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COMMERCIAL LEGAL AND INSTITUIONAL REFORM ASSESSMENTS FOR EUROPE AND EURASIA

Diagnostic Assessment Report for The Republic of Armenia

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Diagnostic Assessment for Armenia

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I. EXECUTIVE SUMMARY

A. Overview

The commercial legal and institutional environment in Armenia can currently be characterized as a system of parallel worlds in which reforms and progress move in different directions at different speed, in unrelated orbits. Basic laws range from quite good to non-existent, supported by institutions that vary from excellent to deplorable. Widely divergent experiences of investors in navigating the system belie an unstable rule of law. In short, all evidence points to a dysfunctional system with unpredictable pockets of success and failure.

Although much progress has been made in the past five years in upgrading the legal framework, at least in terms of legislation passed, the fact is that the system of legal reform and the implementation of those reforms are troubled. There is no formal mechanism for including the private sector in the legislative process, so that most essential stakeholders are less participants in the process than victims of it. Change is based on individual access to the system through relationships, not systemic interaction between those who pass laws and those who are affected by legislation.

Courts are wholly unreliable in their ability or willingness to provide predictable outcomes based on clear legal reasoning through a standardized set of procedures. There is no effective system of arbitration or other alternative dispute resolution for commercial conflicts to supplement or bypass the courts. Large investors noted that they were too easily able to manipulate the system in their favor, while litigators found that only very simple legal issues could be successfully prosecuted in court based on law – and a great deal of persistence. In other words, the courts can work properly, but seldom do, giving rise to strong suspicions of corruption.

Much of the basic legal framework is in place for commercial development and economic growth, but one essential element is missing altogether. There is no proper legal framework for secured lending, the foundation for the growth of credit and financial liquidity. At the micro-enterprise level, a number of assets are effectively used to secure and enforce debts, but this is based more on relationships between the lender and the intimate community where the loans are made than on legal framework. Banks offer very little collateralized credit, and Central Bank regulations do not provide for any reduction in reserve requirements for secured loans, in part because such loans may not be enforceable through the courts in the event of non-payment.

Demand for change, along with local human resource supply for defining the needed changes, is quite high. However, the demand is unfocused, with few organizations able to speak effectively for the interests of their members. Moreover, the lack of a mechanism for public debate and private sector interaction means that organized interest groups can be either irrelevant to the process or unduly able to manipulate the process without proper consideration for countervailing interests.

B. Investor Perspective

Investment decisions are made on the basis of return on investment, or profitability. The factors determining this profitability are the initial cost of investment (sunk costs), the cost of doing business (recurring costs), revenues, and risks. Investors do not generally look at the overall legal framework per se, but at stability of the investment environment and predictability of outcomes so that they can manage costs and risks in order to ensure a sufficient level of return.[1] A healthy legal environment (which must include laws, legislative process, and implementation) helps to provide such stability and attract a wide range of investment. Armenia's environment is not healthy.

Investment in Armenia is currently a high-risk venture based due to lack of predictability. Laws change too frequently and without notice, subjecting investors to unexpected changes in the investment environment. Commercial conflicts cannot be resolved effectively on the basis of law, hindering the growth of larger investments based on a secure climate in favor of smaller transactions based on face-to-face trust relationships.

Corruption also raises costs and risks. Reports of corruption in interactions with customs, tax, registration, licensing and other government agents were widespread. The aggregate amount of required illegal payments tended to be more of a nuisance for larger investors, but an absolute bar to formal activity for smaller actors. On the other hand, even those who could afford to pay the fees or with clout enough to resist them, found that there was a high psychological cost to the regular abuse of authority being exercised at too many levels. Moreover, a number of investors noted that the actual costs of corruption have increased in the last few years, with more officials demanding bribes, or the same officials demanding them more frequently.

On the risk side, corruption in Armenia is undercutting predictability on two levels. First, it makes it difficult to plan effectively for the costs associated with corruption, either in terms of paying bribes or mobilizing resources to fight against the bribery. Second, it can dramatically affect the competitive environment by distorting the rules of the game on an individualized basis. Importers claimed that some well-connected competitors were able to avoid customs duties illegally and thus undercut prices. This affects both revenues and risk.

As a result of the instability in the investment environment, Armenia is sending the wrong message to potential and existing investors, both foreign and domestic. Despite the attempts to woo foreign capital through investment promotion efforts, investors are hearing a different message: "Put your money elsewhere." Unfortunately for Armenia, they are listening, and many are leaving. Disinvestment by higher-end investors and depopulation due to emigration of the young and rural poor are serious concerns for the overall health of the economy.

[1] Good individual investment opportunities can exist in dictatorships (Samoza's Nicaragua), totalitarian regimes (China), and even chaos (arms sales). Broad-based economic growth, however, requires certain rules and a predictable system of enforcement based on those rules.

C. Principal Priorities

This study has resulted in a number of specific findings on potential assistance for improving the commercial legal and institutional framework for Armenia, which are briefly set forth below in this executive summary and more fully in the body of the report. The most urgent needs – with one significant exception – are not in the laws themselves but in the systems of making and enforcing those laws. The exception is secured financing, for which the existing legislative framework is wholly inadequate.

1. Legislative Process

The Armenian system of lawmaking effectively excludes the private sector from the process of making laws. As one respondent noted, "Our input into the system ends with the election of our deputies." There is no legal requirement that laws or regulations be subject to public notice or comment, much less be subject to meaningful discussion and revision based on the needs of those affected by the laws. As a result, the system is both ineffective in creating the consensus needed to ensure effective adoption, implementation and enforcement of laws, and is subject to inappropriate manipulation by powerful individuals or elite groups. From an investor standpoint, this creates a high-risk environment unless the investor is one of those able to manipulate the system. From an economic development standpoint, this unduly limits investment to high-risk investors or those who can manipulate the system, undercutting the growth of a wide range of investment needed for broad-based economic growth.

The foremost priority for long-term commercial law development in Armenia is the adoption and implementation of an interactive system of law making that (1) permits all stakeholder groups to have a voice in the debates and (2) allows for revision and amendment of laws and regulations as needed. Simply providing technical assistance to create a well crafted law on any given subject will not meet the underlying need for a democratic process, and may even undercut democratic values if then passed without public debate. Moreover, assistance in creating new codes or specific laws is a "one-off" intervention that does not address the need for a stable but dynamic system of ongoing revision and amendments. By ensuring investors that laws are likely to change rationally through a thoughtful, deliberative process in which they have a voice, the attractiveness of Armenia as a competitive investment destination will increase.

2. Enforcement of Commercial Obligations

The Armenian court system has become highly dysfunctional for a number of different reasons. First, judges and legal professionals have very poor practical knowledge of the many legal changes that have taken place in the past five years. Numerous market-oriented laws have been adopted, but the adoption has not included sufficient public or professional education to permit implementation. According to many respondents, neither the parties nor the courts understand the law well enough to allow for properly reasoned decisions. Indeed, several legal specialists suggested that virtually no one in the legal community truly understood the new *Civil Code*.

This knowledge gap provides room for both guesswork and corruption, but not for predictable outcomes in the courtroom. It also adds to delays, as judges are more likely to postpone decisions on topics they do not understand, and provides a basis for appeals and retrials, adding to the burden on the courts. Several practitioners noted that judges will decide correctly in simple disputes with clear legal principles (such as non-payment of debt) without bribery or improper influence, but that the lawyers must persistently push the case through due to poor case management and court administration. In fact, one case in the past year involved a decision against a significant government official, suggesting that many judges are prepared to do a better job if better equipped.

The lack of knowledge described goes beyond legal issues, however. Part of the problem in the Armenian judiciary (as in other transition countries) is that the role of the judiciary is unclear or misunderstood. Under former regimes, the courts were just another tool of the state to impose political decisions based on political motivations, not an honest broker responsible for implementing the rule of law. As a result, there is little respect for the courts or the judges, and little understanding of what they should do. Judges do not run courtrooms effectively, and parties are able to unduly delay proceedings with impunity, in part because there is no understanding of the economic impact of such delays and abuse of process. Judicial reform in Armenia must be founded on a new understanding of the role of courts in a democratic, market-oriented economy.

It should also be noted that even well reasoned judicial decisions are being undercut by the lack of any access to those decisions. Judicial decisions and opinions are often not written, and almost never published or otherwise made publicly available. It is simply not possible to reduce corruption significantly or to allow necessary incremental revision of law without public access to the decision-making process.[2] This can now be done quite easily through computer-based systems, but must be accompanied by training for judges in the art and science of writing decisions.

The good news in the judiciary, at least for commercial transactions, is that a new commercial court system has just been established, and includes some very good reform-minded judges. For commercial obligations, this new set of courts offers an excellent opportunity to start changing the legal and judicial culture for enforcement of contracts.

3. Availability of Credit through Secured Transactions

Armenian commercial legislation does not provide adequately for economic growth through the expansion of credit. Although some credit is available, secured lending does not function in a normal manner, resulting in poor liquidity and high cost of funds.

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[2] Many civil law specialists object that the idea of published decisions is a common law concept not relevant under their system, which does not observe precedent. Aside from the fact that the two systems are merging substantially in approach throughout the world, civil law does recognize the principle of consistency, in which judges and lawyers will examine prior decisions to ensure consistency in applying the laws. Moreover, both systems require that decisions be made on the basis of proper findings of fact and law for purposes of appeal. Without quality written opinions, there is no meaningful basis for appeal.

Asset-based lending with pledge registration permits lenders to lower their risk of non-payment by securing assets of the debtor as leverage in the event of default, while permitting the debtor to use the assets for commercial production and activity. Risk is lowered in three ways. First, the lender can repossess the assets, sell them, and recover at least a portion of the loan. Second, and more importantly, the ability of the lender to repossess the assets acts as a strong incentive for debtors to continue payment. In mature economies, repossession value is not nearly as important as this enforcement value. Third, by registering their interest in pledged assets, lenders ensure that borrowers cannot defraud them by selling the assets to an innocent third party who keeps the property free of the lender's claims while the borrower absconds with the money. Under a pledge registration system, there are *no* innocent third parties in a transaction involving property subject to registered pledges.

Armenia's parallel worlds appear very clearly in the context of secured lending. At the upper levels among commercial banks, there is very little meaningful secured lending. This is due to a lack of legal infrastructure to support such lending – specifically, the lack of notice to third parties through registration – and to the lack of enforcement. Commercial bankers unanimously bemoan the absence of effective repossession, re-sale, and recovery mechanisms within the courts or the private sector. In fact, Central Bank rules for collateral lending do not recognize any reduction in risk, and thus do not provide for reduced reserve requirements. In addition, the rules require at least 100% collateralization under a system commanding rather high interest rates.

On the small and medium enterprise level, several organizations are providing secured credit, albeit at high interest rates. Several lending programs sponsored by donors are using land, houses, inventory, and even livestock as collateral and effectively enforcing their contracts through the courts in the rural communities. In fact, almost all of this lending is secured lending. It is not, however, based on pledge registration as much as on the intimate nature of small communities and the awareness that default will cut off any opportunity for future credit. In many ways, registered pledges on collateral is a system for replacing trust between strangers; in a small farming community, trust and community pressure are still partially available without registration. To expand lending into the anonymous society of larger population units, such as regions and cities, registration becomes essential.

Armenia may not yet have the laws it needs to establish secured financing, but it does have the foundation for the registration system. The Land Cadastre office is fully capable of expanding and adapting its present land registration system to cover pledges, and this could be done very rapidly. In addition, there is a solid, well-funded program for leasing that is being prepared for Armenia by international banks and donors, and a great need for this service. Thus, the supply and demand sides are very much in place for the introduction of leasing, but a system of registration is needed first as a foundation for this form of asset-based lending. This will also require new laws and regulations to support the system.

D. Summary Findings for Each Area of Commercial Law

1. Bankruptcy. The legal framework for bankruptcy law is in flux. A new draft has just been issued to replace existing legislation, which was usable but not up to international standards.

The proposed draft appears to be an improvement, depending on any changes made in the process of review and passage.

More importantly, there is a general lack of any understanding within the judiciary (and most of the legal profession) of even the basic concepts of bankruptcy. The new law will do little to improve bankruptcy practice without substantial training for participants in the process, including judges, lawyers, administrators, evaluators, enforcement agents and even the general public. This is not unusual for a transition country, but it is essential if the legislative reforms are not going to be just a waste of money and effort.

2. Collateral. As already noted, Armenia does not have either appropriate legislation or supporting institutions (a registry) for the growth of modern secured financing. There is some well-designed use of assets in rural micro-lending programs and some mortgage-based lending; the system needs substantial work, both in laws and training. In addition, supporting institutions such as the bailiffs are insufficient for enforcement of the modern laws (and even the existing laws).

3. Company Law. There have been a number of recent improvements to the legal framework for companies, which will take time (and education) to absorb, and which will eventually need some refinements. Legislative change is not a high priority for the present, however. The Company Registry has recently undergone substantial improvements, with registration times dropping from 45 days to one week. This can be improved even more with continued streamlining and computerization, but most users are generally satisfied with the changes so far. Perhaps the more important area of need is in development and understanding of the principles of corporate governance among courts and businesses.

A subset of Company Law needing attention is in the area of non-governmental organizations, including not-for-profit organizations and civil associations. The existing law was cited frequently as problematic, and is a good candidate for project assistance.

4. Competition. The legal framework is adequate but far from perfect, and will need ongoing revision once it is effectively being implemented. The greater problem is in a lack of implementation: to date the implementing institution has brought no cases under the law, but instead is focusing on baseline studies. Supporting institutions have no experience with competition issues, and public understanding of the benefits of competition is not good. This area needs a great deal of long-term assistance, based on experiences in other countries.

5. Contract. The 1998 *Civil Code* and ancillary legislation provide an adequate legal framework but are not well understood. Due to problems of credit and enforcement, most business transactions are done on a cash basis, with few complex contractual relationships possible in the broader legal environment. To the extent laws support development of contract practice, there is pervasive lack of legal information or continuing legal education to enable practitioners to understand and take advantage of the numerous legal changes underway. Several legal specialists opined that virtually no one understands the new 1998 *Civil Code*.

6. Courts. As previously noted, the courts are in crisis. Not only is the judiciary not functioning effectively, the support mechanisms such as the bailiffs' office are not adequate for the country's

development needs. The best opportunity for improving the judiciary and beginning the needed fundamental changes in judicial culture is in the newly created commercial courts, which do not yet have the baggage or negative reputation of other courts. Assistance is badly needed.

7. Foreign Direct Investment. Armenian FDI policy is an example of why many development professionals are opposed to having a separate FDI law or code. Although it covers many of the concerns of foreign investors (repatriation, non-discriminatory treatment, guarantees against expropriation), it misses the larger picture. The investment climate is simply not attractive for foreign or local investors, and tax breaks for million-dollar risk takers are simply not enough to attract meaningful investment. Even worse, Diaspora investors are coming in fewer numbers, and many of those who have tested the market have limited their investments or left altogether.

The investment promotion agency has a good grasp of marketing and investment promotion concepts applicable to an attractive investment climate, but is poorly focused on "risk takers." Unfortunately, this approach is unlikely to yield results, while more conservative investors (both local and foreign) are being ignored. Worse yet, the system discriminates against Armenians in favor of foreigners. Much rethinking is needed about the nature of investment and how to attract it.

The intellectual property regime, a subset of the foreign investment regime, is generally sound at the legislative level, with most necessary legal provisions in place. Like other areas, implementation is poor and the implementing institutions need to be strengthened.

8. Real Property. With the support of several donor organizations, the real property system has undergone some very positive reforms and improvements in the past few years. The law is basically sound and modern, with few needed changes other than hidden liens and restrictions on foreign ownership (which do not work). The cadastre and registry are being harmonized very effectively and receive strong approval ratings from stakeholders. Among the supporting institutions, the real estate associations have not become self-sustaining as envisioned at the levels attained under donor programs, but continue to offer services and lobby for reforms. The main challenge to the system is in mortgages, where inappropriate monopolization of the auction system by bailiffs is having a negative impact on enforcement and recover of costs in the event of default.

9. Trade. Armenia is substantially in compliance with World Trade Organization requirements and is actively pursuing European Union accession, so that reforms are heading in the right direction. For the implementing institutions however, there are critical problems in all agencies. Program assistance has just started for the customs service, but other assistance is needed for trade promotion and other areas of compliance. In addition, supporting institutions such as business associations are generally weak, so that the private sector has little input into the trade policy agenda.

10. Cross-cutting Issues.

a. *Corruption*. Respondents at all levels complained of systemic corruption at increasing levels. Complaints focused heavily on abuse of power by state officials such as police, customs, and tax authorities, as well as perceptions of corruption in the courts to obtain favorable

decisions. While some of the criticism focused on bribery, there was also a theme that can best be characterized as corruption of the system. That is, because there are no formal mechanisms for generalized access to legislative and policymaking processes, powerful individuals and interests can manipulate the system in their favor without proper consideration for other valid interests. For those considering investment, this system creates serious uncertainties about the ongoing climate for business.

Corruption will need to be addressed by numerous donor and local entities on numerous levels. For the commercial climate, institution and implementation of requirements for published legal opinions and formal mechanisms for private sector participation in the legislative process will have a substantial impact.

b. *Legal Information and Education*. There is a severe shortage of legal information in Armenia. The official gazette publishes only one thousand copies of new laws, which are made available in hard copy only, not electronically. An electronic version of the laws is available, but the service (providing DOS-based, 1980s-style electronic files) has attracted only 60 subscribers so far. Recommendations were recently made about e-government solutions, which may be the most cost-effective approach to getting the law to the public and to legal practitioners.

Legal education is improving. The American University of Armenia is providing a valuable didactic option through modern teaching methods and updated legal courses. The Yerevan State University Law School also is undergoing some reform in its methodology and curriculum, although there continue to be holdovers from the Soviet era in both style and content. However, there is no institution or formal system for continuing legal education. This is a serious problem for the legal community, especially in light of the numerous new laws that have been adopted in the past few years and that will be passed in the next few. In short, there is no vehicle to bring legal practitioners – whether lawyers, judges, or legislators – up to date in legal developments.

c. *Economic Environment*. Although much can be done to improve the commercial law and institutional environment for Armenia, the most important constraint facing the country is market size. Without involvement in regional trading groups and strong trade links with neighboring countries, the Armenian market is simply not large enough to attract investment or support much trade. Overcoming this will require political will to re-open the borders with Turkey and Azerbaijan, something well beyond the scope of a commercial law reform project. While such changes are being negotiated, however, Armenia can prepare for greater trade and investment by improving the existing environment along the lines noted in this report. Good laws and institutions may not be sufficient to attract investment lacking good investment opportunities, but they are essential to economic development when the investment opportunities appear.

II. INTRODUCTION

A. The Armenian Assessment

At the request of the USAID Mission in Yerevan, Armenia (USAID/Yerevan), Booz Allen Hamilton ("Booz Allen") has undertaken a Commercial Legal and Institutional Reform Assessment of the Republic of Armenia.

Broad Indicator	Albania	Armenia	Croatia	Kazakhstan	Macedonia	Poland	Romania	Ukraine
Population (millions)[3]	3.49	3.36	4.28	16.73	2.04	38.65	22.41	49.15
Area (km2)	28,748	29,800	56,538	2,717,300	25,333	312,685	237,500	603,700
1999 GDP Per Capita[4]	$1,650	$3,000	$5,100	$3,200	$3,800	$7,200	$3,900	$2,200
% GDP - Agriculture	54	40	9	10	11	4	16	14
% GDP – Industry	25	25	32	30	28	33	40	34
% GDP – Manufacturing	--	--	21	23	--	20	30	29
% GDP – Services	21	35	59	60	60	63	44	51
Foreign Aid Per Capita[5]	$72.50	$54.73	$ 8.70	$13.30	$45.80	$23.30	$15.80	$7.60
Corruption Index[6]	2.3	2.5	3.7	3.0	N/A	4.1	2.9	1.5
Economic Freedom Index[7]	3.70	2.95	3.50	3.70	N/A	2.80	3.30	3.60
Government Effectiveness Rating[8]	-0.653	-1.03	0.150	-0.824	-0.576	0.674	-0.570	-0.893
Regulatory Framework Rating	-0.700	-0.53	0.236	-0.405	-0.312	0.565	0.199	-0.721
Rule of Law Rating	-0.918	-0.35	0.146	-0.590	-0.256	0.538	-0.088	-0.707

[3] CIA World Factbook, July 2001 estimate: www.cia.gov/cia/publications/factbook.

[4] CIA World Factbook; 2002 estimate.

[5] The World Bank: http://devdata.worldbank.org/query . Figures are from 1999 and are in current US$. As a point of comparison, foreign aid per capita in all developing countries for the same period was $8.40.

[6] Transparency International 2001; Corruption Perceptions Index. Scale = 1 - 10. Higher scores indicate less corruption: http://www.gwdg.de/~uwvw/.

[7] 2001 Index of Economic Freedom Rankings, The Heritage Foundation: www.heritage.org. Scale: 1-1.95, free; 2-2.95, mostly free; 3-3.95, mostly not free; 4-5, repressed.

[8] Worldwide Governance Research Indicators Dataset 2002, The World Bank. Governance indicators reflect the statistical compilation of perceptions of the quality of governance of a large number of survey respondents in industrial and developing countries, as well as non-governmental organizations, commercial risk rating agencies, and think-tanks during 2000/01. Governance indicators are measured in units ranging from about -2.5 to 2.5, with higher values corresponding to better governance outcomes. This footnote applies to the Government Effectiveness Rating, Regulatory Framework Rating, and Rule of Law Rating: http://www.worldbank.org/wbi/governance/datasets.htm#dataset.

The purpose of assessment was to assist the USAID/Yerevan in its strategic planning so that programmatic resources can be focused on high priority reform needs for additional legal and institutional reform work in Armenia.

This assessment was carried out from December 2-17 by a team of six expatriate lawyers with invaluable assistance from USAID/Yerevan and local private-sector counterparts. The team members and their areas of specialization were:

Expatriate Team		
Judge Vincent Aug	Federal Bankruptcy Court	Bankruptcy, Courts
Yair Baranes	Booz Allen, Legal Reform Specialist	Collateral (Secured Transactions)
Wade Channell, Team Leader	Booz Allen, Legal Reform Specialist	Foreign Direct Investment, Real Property
Nicholas Klissas	USAID/E&E, Legal Reform Specialist	Trade
Veronica Taylor	University of Washington School of Law, Comparative Law Specialist	Contract
Gerald Zarr	Booz Allen, Legal Reform Specialist	Company, Competition
Local Assistants		
Emil Babayan	JD, Yerevan State Univ.; LLM, American Univ. of Armenia	
Lilit Voskanyan	BA, Yerevan State Univ.; LLM (in progress), American Univ. of Armenia	

The assessment consisted of two parts. First, the team reviewed the laws, regulations, and related literature, relying heavily on work by the University of Washington School of Law done prior to the team's departure, with assistance in updating from our local assistants and various legal professionals. Second, the team interviewed numerous government officials, NGOs, multilateral and bilateral donor agencies, judges, lawyers, investors, businesspeople and investors to assess the commercial legal environment of Armenia. (See List of Interviews, attached as Appendix A.) All of them, including the government authorities, were generous with their time and lent full support to this endeavor.

B. Background to the Diagnostic Methodology Used

This assessment is the tenth in a series of assessments carried out since 1998 in a program created by USAID in which Booz Allen Hamilton was retained to assist in the development of indicators and methodologies for assessing the status of commercial legal and institutional reform in a developing or transition country.

The first four assessments — Kazakhstan, Poland, Romania, and Ukraine — were used to devise, refine and field-test the methodology. The methodology and results were then subjected to peer review by approximately 50 legal development professionals at a workshop in Prague during December 1999. On the whole, the participants verified and affirmed both the methodology and results through a "reality check" based on their professional experience in the European and Eurasian regions. Moreover, they provided important input on the indicators used for scoring the countries. Based on this feedback, the indicators were revised during the winter of 2000.

The new indicators (CLIR 2.0) have been used to conduct diagnostic assessments for Albania, Croatia, Macedonia and Serbia. A ninth assessment was conducted in Bulgaria simultaneously with the Armenian assessment.

C. Notes on Scope and Methodology

The diagnostic assessment was designed to help USAID Missions achieve the following objectives:

1. To provide a factual basis for characterizing the degree of development and the status of commercial law reforms in a country;
2. To provide a methodologically consistent foundation for identifying describing the root causes of the "implementation/enforcement" gap; and,
3. To provide analytical and planning tools and metrics that will help USAID design new approaches to sustainable, cost-effective C-LIR interventions.

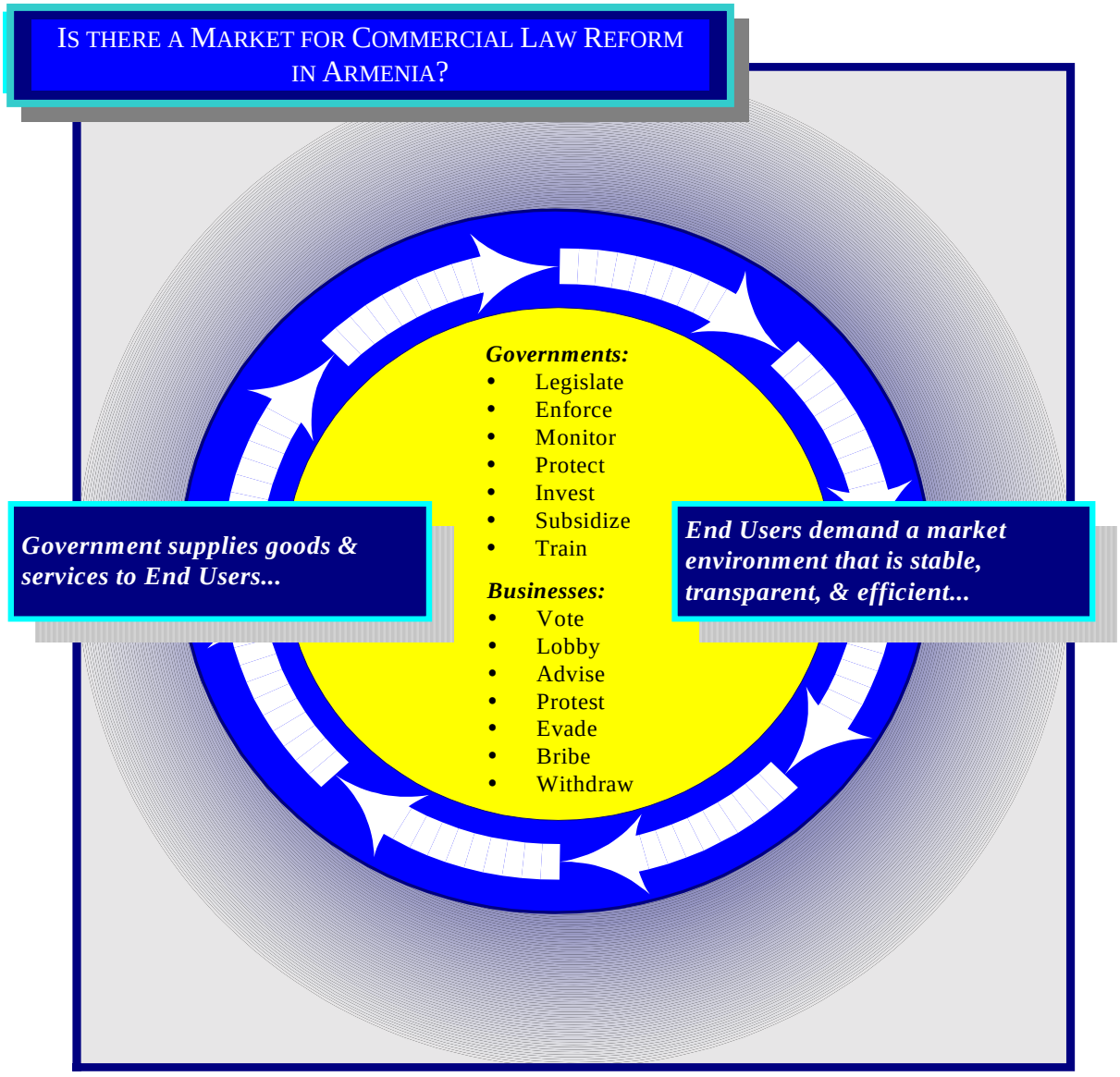
For the purposes of most assessments, "commercial law" is defined to include the following substantive legal areas:

- ***Bankruptcy*** - Mechanisms intended to facilitate orderly market exit, liquidation of outstanding financial claims on assets, and rehabilitation of insolvent debtors.
- ***Collateral*** - Laws, procedures, and institutions designed to facilitate commerce by promoting transparency, predictability and simplicity in creating, identifying, and extinguishing security interests in assets.
- ***Companies*** - Legal regime(s) for market entry and operation that define norms for organization of formal commercial activities conducted by two or more individuals.
- ***Competition*** - Rules, policies and supporting institutions intended to help promote and protect open, fair, and economically efficient competition in the market, and for the market.
- ***Contract*** - The legal regime and institutional framework for the creation, interpretation, and enforcement of commercial obligations between one or more parties.
- ***Foreign Direct Investment*** - The laws, procedures, and institutions that regulate the treatment of foreign direct investment.
- ***Real Property*** – The laws, procedures, and institutions responsible for establishing, maintaining, and preserving rights in real property, including land, buildings, easements, liens, and other interests in real property.
- ***Trade*** - The laws, procedures, and institutions governing cross-border sale of goods and services.

Within each of these substantive areas, four "dimensions" of C-LIR were examined as a conceptual framework for comparison. These include:

- ***Framework Law(s)*** - Basic legal documents that define and regulate the substantive rights, duties, and obligations of affected parties and provide the organizational mandate for implementing institutions (e.g., Law on Bankruptcy, Law on Pledge of Moveable Property);

- ***Implementing Institution(s)*** - Governmental, quasi-governmental or private institutions in which primary legal mandate to implement, administer, interpret, or enforce framework law(s) is vested (e.g., bankruptcy court, collateral registry);
- ***Supporting Institution(s)*** - Governmental, quasi-governmental or private institutions that either support or facilitate the implementation, administration, interpretation, or enforcement of framework law(s) (e.g., bankruptcy trustees, notaries); and,
- ***"Market" For C-LIR*** - The interplay of stakeholder interests within a given society, jurisdiction, or group that, in aggregate, exert an influence over the substance, pace, or direction of commercial law reform.



III. CROSSCUTTING FINDINGS

A number of observations and findings apply to more than one substantive area of law under the diagnostic methodology. For Armenia, in fact, the greatest problems were crosscutting institutional issues involving the courts and legislative processes. Courts serve as implementing or supporting institutions for all areas of commercial law, so that general problems affecting all areas are discussed in this chapter, while specific problems related to specific subject matters are addressed in the subsequent chapters. Likewise, legislative process is an overarching issue for all laws. A number of other observations regarding supporting institutions and market for demand are not specific to each law and are also covered below.

A. General Comments on the Social and Economic Setting

Despite their understandable pride in Armenia's 1700-year history as the first Christian nation in the world, Armenians find little comfort today in that past. The last century did not go well for the country. Armenia was subject to a conflict with Turkey in 1915, in which, it is estimated, from 600,000 to one million Armenians died, while many more were dislocated from what is now western Turkey into the Middle East, Europe, Russia, and the United States. Before recovering from these tragic events, Armenia came under the domination of the Soviet Union, thwarting any possibility that the economy might recover along capitalist, free market lines.

The dissolution of the Soviet Union was a mixed blessing for Armenians. On one hand, they obtained political independence and established their own government on September 21, 1991. On the other, they lost their somewhat privileged position within the former Soviet Union, where they had enjoyed a disproportionate share of trade and economic subsidies. The catastrophic earthquake of 1988, from which some sections of the country are still recovering, compounded this loss of subsidies.

In addition, the dissolution of the old order allowed simmering hostilities from the past to boil over into conflict, resulting in the secession movement of the Nagorno-Karabakh region of Azerbaijan. Although the war between Azerbaijan and Armenia over this ethnically Armenian enclave has settled down into something of a stalemate, the borders to Azerbaijan and Turkey resulting from this war are still closed. Armenia, a small country to begin with, is now unnecessarily isolated.

In short, Armenia was ill prepared economically, politically, and socially to embrace the opportunities for development presented by the dissolution of the old Soviet regime. Recovery and development are proving to be much slower and more painful than anticipated when the Iron Curtain fell in 1989. Armenia has no significant modern history of democracy or market economics to build on. Although there is a large, well-educated, well-financed Diaspora, interested in helping to rebuild the country, there is a wide cultural gap between those Armenians

who created a new life abroad in the developing world and those who survived 70 years of Soviet oppression. Many of the well-intentioned Diaspora Armenians who returned to invest in the homeland of their parents have disinvested and returned to their own homelands as the "Re-aspora."

B. The Commercial Courts of Armenia

During recent revisions to the CLIR methodology, we have decided to conduct a separate, focused assessment of the courts responsible for commercial dispute resolution. Previously, they were studied as the implementing institutions for Contracts, but their impact is much wider than just contract resolution – the courts affect every area of commercial law in the legal framework

1. Overview

The importance of the court system was emphasized during the diagnostic by the unanimous concern among respondents regarding the quality of the institution. Although, as described below, a new set of Commercial Courts has just been established and is still too young to assess, overall satisfaction with the court system is extremely low. Respondents complained of long delays, poor decision-making (when decisions were even issued), and suspicions of corruption. Several of those who had studied the courts felt that even the well-meaning judges and lawyers often found themselves tempted to use bribery to resolve disputes simply because so few people know or understand the law, and thus are not in a position to insist on accountable, transparent decisions. Others have noted that the courts *can* work, but usually only when the legal and factual issues are extremely simple, and one lawyer is persistent in pushing the case through an excessively slow system subject to unnecessary delays.

2. Legal Framework

In principle, the *Law on the Judicial System*; the *Law on the Status of Judges* 1998; the *Law Amending the Law on the Judiciary* 2001 which creates the Economic Court; the 1998 *Code of Civil Procedure* and the *Law on Compulsory Enforcement of Judicial Acts* together comprise the key laws for judicial enforcement of legal rights in Armenia. In practice, the legislative framework is not well suited to commercial cases.

In Armenia, the 17 entry-level courts are called the Courts of First Instance with approximately 110 judges. Their jurisdiction is general, and until October 2001, included all commercial and bankruptcy cases. Now those cases will be handled by the Economic Court, with 15 newly appointed judges.

Appeals from the Courts of First Instance travel up to three second instance Appellate Courts (20 judges) and then on to the single Court of Cassation (13 judges) for final review. Under the *Law on the Judiciary*, economic and commercial cases go before one trial judge in the Economic Court whose decision is to be rendered within one month of receiving the "statement of claim." The decision may be appealed directly to the Court of Cassation. If reversed and remanded, the case returns to the Economic Court to be heard by a three judge panel. Currently, ten judges of the Economic Court are located in Yerevan and five are in provincial centers. In addition, there is a separate Constitutional Court that hears challenges to the Constitution.

Courts of First Instance are currently staffed by approximately 165 judges. Of these, only 29 (17.6%) are women, which is quite low compared to many other transition countries.[9] The average age is well under 45 years

The Constitutional Court has lately issued opinions demonstrating a high degree of independence. The Constitutional Court and the Court of Cassation are generally highly regarded by the people. However, a number of complaints were raised with respect to the very limited standing available for individuals to raise constitutional issues and have them heard by the court. Several prominent lawyers and judges are working together to define the issues more carefully and propose appropriate legislative amendments. Success may be limited or delayed by the extremely closed legislative process, but at least the problem is being addressed.

The lower courts are not at all respected. The fee structure, based on percentages of the amount claimed, is inappropriate and is properly viewed as confiscatory. The Code of Civil Procedure is unnecessarily complicated and needs to be simplified, but the greater problem is a lack of judicial management in pushing cases through instead of permitting unjustifiable delays. At present, there is no Judicial Code of Ethics, which only adds to the public's distrust and belief that the court system is subject to widespread corruption.[10]

The Committee of Court Chairmen housed in the Court of Cassation acts as the main policy making body, administrative agent, and training supervisor (through the Judicial Training Center) for the entire judiciary. A prior Association of Judges became dormant after formation of the Judicial Training Center. Lately, it has been revived because the Judicial Training Center has not adequately responded to the urgent need for judicial training.

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[9] Serbia, Croatia, Bulgaria and even Albania tend to have a fairly even distribution of men and women judges.

[10] It is important to note that the team did not independently verify the existence of corrupt practices. We are reporting impressions stated by numerous respondents, which may or may not be accurate. The existence of such impressions, however, has strong implications for any program designed to create and instill respect for the judiciary.

The courts are technically independent under the Armenian Constitution, with judges appointed for life. Many legal professionals were of the opinion that this is not altogether meaningful, and that there has been significant political tampering with judicial decisions over the years. The conditions for tampering are certainly in place: few court opinions are published, and thus open to scrutiny; pay is very poor; and no system of accountability is effectively in place.

Legal proceedings are predicated on oral hearings, rather than on written briefs and now requires reform. Developed with German assistance, the *Code of Civil Procedure* assumes an activist judiciary that understands modern procedure and that can discipline the parties. This is not happening at present in Armenia in part due to lack of judicial training. Published and accessible judicial decisions, consistency in judicial decision-making, enforcement of judgments and the capacity of ancillary service providers (e.g. bailiffs) remain areas that require strengthening. A minor but telling example of the institutional weakness is that there is no verbatim transcription in court of civil proceedings. The result is that a court record may not be reviewed by the parties and the lawyers until 12 months later. One foreign lawyer now makes his or her own audiotapes of civil proceedings as both a contemporaneous record and as a way of monitoring the judge.

Opinions, while usually written, are not published, and are available only to the parties. Several practitioners complained vigorously regarding the quality of the opinions, describing them as almost Caesarean in brevity and content: like Caesar's famous boast "I came, I saw, I conquered", many Armenian judges are accused of reducing their opinions to "I heard, I considered, I awarded." In general, opinions do not include an adequate description of the legal and factual basis for the judge's award, thus limiting the parties' understanding of the law applied to their case and eliminating any clear record for appeal. Many young judges are eager to see their opinions published.[11] An effort is underway to assemble and publish existing opinions by collecting them from attorneys on a voluntary basis, and private practitioners have also developed a proposal for internet-based publication of new opinions. Other than these private-sector initiatives, there does not appear to be any plan for upgrading the level or availability of judicial opinions at present.

Once in litigation it is not clear that settlement is encouraged or that the courts are able to offer ancillary services such as mediation, conciliation or arbitration. Alternate Dispute Resolution did not figure as a reality in our interviews, perhaps because the system to which it would be an alternate is still in need of such development. Compounding the problems with the judicial system is the fact that there is little ground for compromise or settlement. Foreign investors take their lumps and leave, muttering under their breath, "never again."

Arbitration could be an alternative to the court system: an arbitration system and procedures are provided for under Armenian law. The fee structure, however, is prohibitive. Amendments have been at least partially developed by private sector attorneys, but there is no official project or plan to change the existing, ineffective system. There is some tradition of mediation and conciliation attempted by father figures and go-betweens but this is informal and not judicially enforceable. In summary, there is almost no arbitration or alternative dispute resolution going on in Armenia today.

11 Beginning in January 2002, USAID/Armenia's implementing partner Chemonics International began posting on its website the opinions of the new Economic Court.

With respect to enforcement of foreign judgments and arbitral awards, it was difficult to gauge how they are supposed to function due to lack of English translation of the *Code of Civil Procedure* at the time of this assessment. Assuming that they are enforceable in principle, as a practical matter judges who are struggling with domestic decisions are likely to have difficulty recognizing and enforcing a foreign judgment. Although commercial arbitration does not appear to be used at present in Armenia, enforcement of foreign arbitral awards is theoretically possible because Armenia ratified the New York Convention on the Enforcement of Foreign Arbitral Awards in 1997. In reality, however, it is not possible to obtain judicial execution of commercial arbitration awards. Respondents consistently expressed doubts about the ability of bailiffs to enforce judgments in Armenia, both because delay allows debtors to dispose of or hide their assets and because bailiffs' inadequate salaries and inadequate procedural powers e.g. the power to scrutinize or suspend bank accounts mean that they have little incentive to proceed vigorously.

3. Implementing Institutions

Armenia's courts are heavily limited by their infrastructure. The new Economic Court occupies a Spartan facility outside central Yerevan. The building has unlighted stairwells and no amenities. There will be seven regional facilities, but in the meantime, most regions are sharing space with Courts of First Instance. The judges of the Economic Court have little or no experience in handling bankruptcies. There is an urgent need for training and for adjusting the overall attitude of the judges to the concept of bankruptcy and how it fits in Armenia's shift to a true market economy.

The judiciary is popularly perceived as a clannish institution where political and family connections can be important than merit for admission and advancement. This approach extends throughout the government and all the way down to the government controlled admissions procedure at Yerevan State Law School. In essence, the system works on goodwill rather than on inherent design. One practitioner said that in order to accomplish anything in a clerk's office, first he has to look for friends.

Domestic lawyers generally contend that the courts are not independent in Armenia. They are cautiously critical of the quality of the judges' decision-making regarding contract: some are good, others make bad decisions, but they agreed that courts have little experience of complex litigation or litigation in which foreign law is applied. Judges' vulnerability to influence was accepted as a given element in litigation. Some lawyers felt that bribery was important, stating: "There is no bias in Armenian courts – whoever pays the most wins."

In addition, several respondents insisted that politically well connected investors can manipulate the court system by calling in political influence at the highest levels. This kind of "escalation" of litigation to the decision-maker's superior and ultimately to the Minister of Justice and/or the President is not unusual. Lawyers defended the practice as being their only recourse against a judge who appears biased, has been bribed or who simply has got the law or procedure completely wrong. However, the same lawyers agreed that this corrodes the justice system, earns them the enmity of certain judges and ultimately does not fix the root causes of their dissatisfaction with the courts.

Most of the younger judges will agree that the bedrock change needed for successful reform is a judiciary able to produce reasoned and published opinions. Severe lack of funds for computers and other essential hardware is a problem, but so is fear of exposure among the incompetent judges. Also, losing control of information monopolies means less opportunity for corruption.

Most, but certainly not all, of the newly appointed judges of the Economic Court are in favor of reform, but struggles over jurisdictional issues will surely arise as competing courts seek to refine the definition of "commercial cases" in their favor. On the other hand, litigants will try to avoid calling their cases commercial cases to avoid triggering very large fees. The court fees in these cases are based on the amount in controversy (2%–Courts of First Instance; 3%–Court of Appeals; 5%–Courts of Cassation). These percentage fees do have maximum limits ($2,000 at the first instance), but they can be substantial in simple cases of contract execution or default on a promissory note, for example.

Oddly enough, the modest pay for Court of First Instance judges ($200/month) was not viewed by anyone as a hindrance toward attracting lawyers to the bench. There is no shortage of talent taking the qualifying exam each year and judges are not leaving the bench for the private sector.

The Armenian judiciary lacks a transparent set of court procedures placing the judge firmly in control of litigation and administrative matters. This lack of clear authority stems from cultural distrust, entrenched monopolies (i.e. Bankruptcy Administrators, bailiffs), and a Ministry of Justice that sees a need for judicial reform on the one hand, but fears a dissipation of its power to a truly independent judiciary on the other.

The court will soon be a recipient of part of an $11.4 million loan from the World Bank to improve facilities, for training, and for public outreach and education on court processes. Given that this money will be spread throughout the court system, and given that most regional courts do not even have rudimentary equipment such as copy machines, it is uncertain how far the loan will go to enhance judicial stature or efficiency in appearance or in fact.

4. Supporting Institutions

Various institutions traditionally support the advancement and improvement of judicial capacity in many countries. These include associations of judges, Bar Associations, law schools, and separate judicial training institutes. For Armenia, these organizations are not yet providing the kind of input and support that is needed for a healthy judiciary, but there is evidence that some of them are heading in the right direction.

a. Judicial Training Center

It is surprising that the Judicial Training Center, as a creature of the courts and Ministry of Justice is actually a reactionary force. Numerous offers from donor agencies to fund judicial training have been turned down. Most recently, offers to train bailiffs in valuation and marketing techniques and a grant to improve public perception of the courts were refused. The Committee of Court Chairmen controls this agency on a day-to-day basis, and while some of its members are quite reform minded it is clear that the majority of its members are not. The revived

Association of Judges is eager to make end runs around this vestige of Soviet attitude in order to accomplish its urgent training needs.

b. Bar Associations.

Private Bar – Most commercial lawyers are also affiliated with business and management consulting firms that provide a wide range of services. The Ministry of Justice, in an effort to keep civil courts open to all, actually discourages efforts to require competent, certified legal counsel in all civil court proceedings. The Bar Associations' status is ambiguous because they are not truly state-sponsored and are not non-governmental organizations (NGO). Nevertheless, the Bar Associations (with their 500-600 members) are moving ahead with certification and specialization programs designed to let businesses and the public know who is qualified to practice in various areas. They are also the primary vehicle for licensing and disciplining of attorneys. Unfortunately, incompetent attorneys can still work as consultants and appear in civil court while not being accountable to anyone.

During their three years of operation, the Bar Associations have also begun public outreach programs to educate the public on numerous areas of fundamental rights (such as how to get divorced, what to do if arrested, etc.). The Bar Associations will also be working with the judges of the Economic Court to bring a series of nationwide seminars (town meeting style) and television shows to explain the jurisdiction and procedures of the new court and to familiarize the public with the concept of bankruptcy as a privatization tool.

c. Law Schools

While the law schools are slow to modernize their commercial law curricula, they are moving quickly to develop advocacy skills. These skills were not much in demand during Soviet days, but market driven commercial litigation demands advocates. Both Yerevan State Law School and the American University Law School point proudly to distinguished performances in recent worldwide moot court competitions. The moot court facility at Yerevan State was touted as the finest courtroom in all of Armenia, but we noted the prosecutor's table was much larger than the defense table and the defense table was ringed with jail bar-like spindles for "symbolic" reasons.

d. Bailiffs and Notaries

Enforcement of domestic judgments is provided for by law but is difficult to effect in practice. Bailiffs were uniformly identified as lacking the necessary authority, legal power, salary and prestige that would enable them to enforce judicial decisions. Businesspeople and domestic and international lawyers without exception regarded bailiffs as ineffectual in enforcing judicial decisions, but were sympathetic to their situation. As one domestic lawyer said 'In a gray economy where people do not declare their income, it is nearly impossible to locate their assets'. Among domestic lawyers, the only alternative recommended to clients is self-enforcement i.e. negotiation, or pre-investigation of the other party's assets to determine whether litigation will have any chance of success.

It is hard to conceive of these functionaries as court "supporting institutions" because of their preoccupation with supporting themselves. Nevertheless, as the move to make their operations

transparent gains momentum, a certain competence borne of training and experience will necessarily be required. Training efforts for these groups must be very focused on practical issues and not deep theory. For example, notaries should be familiar with bankruptcy procedures when they are finally developed (especially claims procedures). Bailiffs should focus on topics such as valuation of assets and marketing techniques.

e. Bankruptcy Administrators

As noted before, this group is quickly moving toward increased accountability and competence. The Ministry of Justice is backing this progress and has recently licensed 40 Administrators. At the same time, however, the Ministry of Justice is promoting administrator control over the bankruptcy process to the diminution of the court's independence and power. The bankruptcy court can function under these circumstances for now because almost all the cases are liquidation or no asset cases but it cannot provide a wide range of solutions to all the constituencies in a real market-based insolvency situation. Only judicial control over the system can balance these interests.

5. The Market for Reform.

Whether driven by a true sentiment for reform or by rapidly deteriorating confidence in Armenia among overseas investors, the creation of the Economic Court was a big step in the right direction. Unfortunately, the chaos present in the Courts of First Instance (especially in the area of bankruptcy) is now being transferred into this new court, while the court is staffed by judges with sufficient intellectual prowess but limited experience in commercial law and almost no experience with bankruptcy law. As their dockets pile up, the Ministry of Justice seems to be intent on enhancing the role of Bankruptcy Administrators at the new judges' expense. The demand is strong from the business sector and the two "outside" Bar Associations of civil attorneys for independent judges, published decisions, and transparent court procedures to replace the Byzantine mystery that exists now.

6. Conclusions and Suggestions

The key to judicial independence and respect is reasoned and published opinions. Every effort should be made to support e-governance proposals and to use the Bar and law schools as an army for information gathering. There is no doubt that the Association of Judges would supervise the publishing of opinions if funding were available. Judges also need bench books on procedure and training in fundamental economic theory to understand that law can enhance investment and economic growth with predictable, enforceable processes open to all stakeholders. Training in the United States of America and countries like Estonia with its remarkable e-governance success story should be considered.

It was surprising how many organizations were involved in grass roots education on fundamental rights. Young professionals and the business community should back these efforts to help the public bolster the calls for reform.

Armenia has done more than most CIS countries to rid itself of the old Soviet bureaucracy. There is also a perception that the worst corruption of the post-Soviet days may be over. In

short, most of the old Communist bosses have made their money. There are no longer insurmountable pockets of resistance to reform. This picture of an opportune moment for reform needs to be presented to the world.

Information mechanisms should be created to give the outside world, the Council of Europe, and other international bodies reports if indeed real progress is achieved in the coming months. Armenia must recover from so many obstacles, and must be seen to be recovering in order to coax back wary overseas investors and to build the morale and confidence to stimulate real internal growth.

Finally, allowing the new Economic Court judges to see successful foreign commercial courts first hand will go a long way to broadening their outlook on the question of judicial independence called for in the Armenian Constitution. This reorientation of mentality is fundamental for any meaningful and lasting modernization.

IV. SPECIFIC SUBJECT MATTER AREAS

As noted in the Executive Summary, the commercial law regime in general is sufficient for the time being to support growth of the commercial sector, at least as far as the laws are concerned. As one practitioner noted, however, "the system is broken", so that the laws alone are not enough to support the needed growth. The court system is ineffective, the legislative process is wholly inadequate, and legal information is insufficient. Moreover, spotty and inconsistent enforcement has created a high level of cost and risk for investors, and they are expressing this through disinvestment in some instances, or much lower rates of investment than planned.

There are, however, specific areas in need of support or reform, and specific areas where the law and the underlying system are moving in the right direction. These are set forth below.

A. Bankruptcy

1. Overview

Two recent developments have the potential to bring some semblance of order to a rather chaotic bankruptcy system in Armenia. The first is a major revision of the substantive law that is headed for passage sometime in March 2002. The second development is the creation of a new specialized court called the Economic Court. The latter began operations in October 2001 and will have jurisdiction over bankruptcy and other commercial law cases.

To give some idea of the confusion surrounding bankruptcy practice, the Chief Judge of the new Economic Court does not know how many pending bankruptcy cases are now being transferred from the Courts of First Instance to the new court. A year ago there were approximately 215 bankruptcy cases. At that time, however, there was a nationwide moratorium on new filings because the Parliament had inadvertently omitted any reference to bankruptcy in its latest revisions to the *Civil Code* (which is also weak in several other areas of commercial law). That moratorium was lifted six months ago. However, bankruptcy is still perceived by most stakeholders to be an experience fraught with corruption, ineptitude, lack of administrative resources and an overall poor alternative to privatization as a means of recycling unproductive assets. It is not understood in general as a means of rescuing or reconstructing a company in distress, being used primarily for liquidation.

Furthermore, there are hardly ever attorneys representing the parties in bankruptcy cases. Financial records are either non-existent or a mess. While notices and meetings of creditors are generally held in a timely fashion, there is a general lack of consensus about the judge's role in the process and poor development of issues and representation of rights. A bank department clerk will often know more about bankruptcy law and procedure than a Court of First Instance judge, and judges will often call them for guidance. As one private attorney said, after handling a recent liquidation proceeding, "No one knows what to do, and the law is unimportant."

In sum, bankruptcy is a cumbersome, expensive and risky collection device used almost exclusively by politically powerful creditors (banks and taxing authorities) with widely varying

degrees of success. Even though bankruptcy relief is available to companies and individuals, it is believed that no debtor has ever initiated bankruptcy proceedings.

2. Legal Framework.

The stakeholders interviewed usually agreed that the law, while problematic, is potentially workable as a liquidation tool. Those responsible for past and pending drafts of the legislation nevertheless acknowledged numerous serious shortcomings with the present status of bankruptcy practice. One practitioner described the law as "software code for the wrong operating system." The most prominent problems include:

- *Case commencement criteria*. Small creditors can trigger very expensive processes against large enterprises. Some filings (by tax authorities) are mandatory. There is little flexibility. The cost to file a case is $900. It is often wasted because of procedural snarls causing dismissal.

- *Appointment of administrators*. Administrators are appointed through questionable Ministry of Justice processes, often bypassing involvement by the judge or creditors' committee.

- *Compensation*. Bankruptcy Administrator compensation is so low that cases are often purposefully delayed to run up fees. There has been a low level of professionalism among Administrators until very recently.

- *Process deadlines*. Deadlines for gathering financial data, completing inventories, conducting analysis and evaluating claims are unrealistically short.

- *Insufficient notice*. Notices do not fully inform creditors of their rights and responsibilities to document claims. Broad public notices are not required. Creditors are often confused and unprepared when attending key events.

- *Imbalance between roles*. Administrators have become more powerful, to the diminishment of independent court supervision.

- *Protection of assets*. There is confusion about responsibility for safeguarding assets. Assets frequently disappear or are looted.

- *Valuation of assets*. Valuation and sale of assets by Administrators and bailiffs who are inexperienced or inept make this an area rife with corruption.

- *Lack of documentation*. Decisions of the court are not published. The *Civil Code* provides that only the parties receive copies of decisions.

- *Insufficient authority to settle*. It is legally very difficult to settle or compromise a tax claim without legislative approval. These are usually the biggest claims. This makes reorganization impossible most of the time.

Concerning the legislative process, it should be noted that Russian and American experts assisted in drafting a rather clean and efficient reform Bill this fall. That draft, 75 articles in length, mysteriously disappeared from any transparent process for 60 days last September and emerged recently with 126 articles. It is unclear who had input on these amendments and additions or what political deals were made. The result, however, is a verbose, complex draft that clearly favors increasing Bankruptcy Administrators' influence at the expense of the so-called independent judges of the new Economic Court.

3. Implementing Institutions

The Economic Court with its 15 newly appointed judges will handle all bankruptcies. This institution is covered thoroughly in Section III B, Commercial Courts (starting at page 15).

4. Supporting Institutions

The business community is a strong influence pressing the Ministry of Justice to bring the bankruptcy/commercial law environment into some form recognizable by the Council of Europe (which Armenia has just joined) and the rest of the developed world.

Surprisingly, in a nation that is losing its young population to emigration at an alarming rate, there is a substantial, vocal and talented reservoir of (mostly young) professionals to make this commercial law reform a reality. Among the interested parties are:

- *Business Organizations*: The American Chamber of Commerce – AmCham – is a vital organization with a number of projects including an "e-governance" initiative to bring transparency and searchability to government processes, decisions and decision makers. Its members and officers include lawyers with U.S. and other foreign education and experience who represent many of the larger domestic and foreign investors.

- *Association of Accountants and Auditors of Armenia* has instituted programs for training and certification. The skills of its members (650) will be needed to bring the bankruptcy practice up to the standards of developed countries.

- *Bar Associations*: There are three Bar Associations with a move afoot to consolidate them. Only one Bar Association is state sponsored and may not refuse to admit members. The Young Lawyers Association also has 200 members, runs 7 pro-bono clinics and had produced 14 excellent public outreach pamphlets explaining basic legal rights and remedies. We see no reason to support consolidation of the various associations, which should be left to market forces. The interest in consolidation appears to arise from a holdover mentality that emphasizes control, based on an older model of Bar Associations in which one state-sponsored group has monopoly rights over any formal association of lawyers.

- *Bankruptcy Administrators*: These key people in the bankruptcy system are finally getting organized and have formed a union. The Ministry of Justice is now certifying

them. Training in fundamental bankruptcy concepts, record keeping, valuation and marketing has begun in earnest. One new draft of the bankruptcy law requires the Administrators to self-insure and self-regulate as an incentive to weed out incompetence and corruption. Although the Administrators operate in an environment of severe lack of funding for the administration of cases mixed with political pressure and fear of public reprisals, it was noted by several respondents that the Administrators are of late operating more independently and with more of a sense of professionalism. Some suggested that the oversight and training from the Ministry of Justice and growing experience with the law is producing a higher quality of Administrators, many of whom possess a clearer and more comprehensive understanding of their duties.

- *Law Schools*: Although the law schools at Yerevan State and the American University have not done much to recognize bankruptcy as a separate legal discipline, there is a growing awareness that world markets and foreign investors will require a solid commercial law structure that includes predictable insolvency procedures. Should the drive for "e-governance" promoted by the business community ever take hold, the law schools and Bar Associations will be eager to provide the manpower to bring to light (via the Internet) the procedure, customs and decisions of those in power. The talent and energy is there to make government processes transparent, but so far the political will has been lacking.

- *Notaries and Bailiffs*: As the gatekeepers and undertakers of the system, these two factions are the most entrenched monopolies presenting obstacles to modernization. The notaries provide all sorts of services in reviewing documents and assisting the public in routine legal matters. In a system with a vibrant private Bar, they would be superfluous. Oftentimes, they do little more than provide comfort to a public conditioned to fear any contact with the bureaucracy. The bailiffs, as chief enforcers of court orders, have no trouble maintaining their monopoly in a culture suspicious and tentative about the concept of private property. There is little opportunity or will for self-help repossession of collateral or automatic compliance with court orders just because a judge has ruled.

In sum, there are a number of institutions and individuals that form a foundation for potentially successful reform initiatives in bankruptcy law and practice. In terms of priorities, procedural rules should probably come first, then training and acclimatization to respected bankruptcy norms, and then the loosening of the grip of entrenched bureaucracy by a judiciary that is in charge of the system. This will take time, but there is a growing minority of young professionals who know what needs to be done and are willing to do it.

5. The Market for Reform

A few years ago, the formation of a specialized commercial court was hardly imaginable. The pressure for reform has come from the business community and a small group of reform-minded politicians. This is not unusual, as bankruptcy law is seldom understood in any country on a popular level, but instead is reformed by the practitioners, with support from the business community, in concert with policy makers. The urgency of the matter is driven by severe population loss and a drying up of foreign investment. This country, which has been busy surviving massive earthquakes, embargoes, wars with neighbors, corruption and political

upheaval occasioned by assassination, has no commercial traditions on which to build a future. The old nepotism and featherbedding of the past decade are too well known by the outside world to sustain a climate for modern government and real economic growth. Because Armenia has hit this low point, a growing number of government officials and professionals are ready to do what it takes to join the world business community as quickly as possible.

6. Conclusions and Suggestions

At this threshold moment in the development of commercial law and bankruptcy practice in Armenia, focused effort should be made to encourage the forces of reform. Training of judges and court officials is probably the deepest need. Support for e-governance and other grass root initiatives to educate the public about government processes are also critical. The pro bono clinics and public education programs of the Young Lawyers Association and Yerevan Law School are impressive and offer a base on which to build reform efforts. Assistance to these programs will eventually reduce the fear of government and enhance a more broad-based demand for accountability and openness.

B. Collateral (Secured Financing or Pledge of Movable Property)

1. Overview

a. The need for Credit in Armenia

There is no doubt that increased use of credit is necessary for the Armenian economy to achieve the steady growth needed for the country to develop. Small, medium and large businesses need financing in order to be able to purchase new inventory. Contractors, such as construction companies, need financing in order to purchase new and larger equipment to be able to bid and perform larger contracts. Manufacturers need financing in order to purchase new machinery to increase their productivity. Farmers need financing in order to purchase seed, inputs, and farm equipment. Finally, consumers may need financing in order to purchase new consumer goods such as new vehicles or household appliances and furniture.

Currently, most financing is restricted to self-financing; that is, from one's own capital and revenues. This source of investment funding will not support significant growth, and is available only to a few. Profit margins are rarely high enough to provide excess revenues sufficient to cover operating costs, return on investment, and capital for expansion. Financing through programs by international donors may be available as an interim measure for a few investors, but it is only a short-term solution, not a self-sustaining system of financing a modern economy.

The most efficient source of financing is commercial credit. Credit provides investment and operating capital that can be used to increase production and productivity, through which Armenian businesses can generate increased revenues to repay their loans while providing for their ongoing needs. For example, commercial credit may enable a farmer to purchase fertilizer or irrigation equipment to increase production on existing holdings and then repay the loans from increased profits. Likewise, businesses can increase inventory to meet short-term surges in market demand through inventory financing, rather than miss opportunities due to cash shortages, and repay the credit from increased sales.

b. The Risk of Granting Credit in Armenia

A healthy credit environment must permit lenders to manage risk of non-payment effectively. In Armenia, this risk is currently very difficult to manage. As a result, credit is very limited in the country, and on very poor terms. High interest rates (25-46%) are used to cover the high risks, making credit unaffordable to many and more difficult to repay. Most loans are also for small amounts ($1,000 or less) and short terms (mostly for 3 to 12 months).[12]

The most efficient and by far the most common way to reduce this risk is to reduce the risk of default for the lender and provide a method of reducing losses in the event of default. This is accomplished though the use of the debtor's property. In case the borrower fails to repay the

12 One financial institution has mentioned that some borrowers may be able to enjoy lines of credit for up to three years. While this is an important phenomenon it has very little significance as the high interest rates on such loans remain at the same level and the property required securing these loans usually remains with the credit provider.

loan, the credit grantor can seize the debtor's property described in the loan agreement, sell it and use the proceeds of the sale to satisfy the loan. The threat of this repossession also ensures a higher level of compliance. This system is often referred to as secured financing or an asset-based financing system.

Armenia does not currently have the infrastructure for a modern system of secured financing. As a result, financing by way of credit is very risky and very rarely available. In jurisdictions where modern secured financing systems exist, credit is both available and affordable, supporting a higher level of economic development and growth.

2. Legal Framework

While there are several factors constraining the availability of credit in Armenia, one of the most important is the state of the law. If a legal system does not provide sufficient assurances that the credit grantor can reclaim the debtor's property and use it to satisfy the unpaid debt in an efficient and expeditious manner, there is very little chance that careful credit grantors will engage in credit transactions. Legal predictability is a great facilitator of commercial transactions. Legal uncertainty discourages parties from entering into legal relations.

Note: USAID has begun a program of substantial assistance in the creating a proper framework for collateral law based in great part on this assessment. Many of the legislative weaknesses raised below are expected to be addressed; however, this work is ongoing, and it is not possible to capture these developments in this report.

a. Priorities

For all practical purposes, Armenia does not have the legal basis to support modern secured financing when it comes to movable property. Although in theory some concepts of secured financing based on movable property exist under Armenian law (See *Civil Code* Art. 226 and 232 for pledges; *see* also *Civil Code* Art. 504 and 507 for conditional sale agreements), these tools are based on the creditor remaining in possession of the property. The *Civil Code* requires such possession in order for the creditors to have protection against third parties that subsequently deal with the debtor and acquire rights in the movable property.[13] Thus for example, a bank that finances a purchase of a tractor by a farmer would have to remain in possession of the tractor until the borrower-farmer fully repays the loan. This is required according to the law so the farmer will not be able to sell the tractor to a third party or grant it to secure a subsequent loan before repaying the first loan.

This kind of transaction is called a "possessory pledge" and is particularly common among transition countries with a civil law tradition. The problem with this approach is that it destroys the benefit of modern secured financing, shifting all risk to the borrower without any

13 Financial institutions indicated that even with this kind of transaction the loan is provided only if the borrower has precious metal such as gold available to be deposited with the creditor. In some cases the creditor may agree to possess larger property. However, this is only for a short period of time due to the additional costs involved in holding, maintaining and insuring this property.

corresponding benefit. In the example above, the farmer is unable to use the tractor to produce income, but must incur costs relating to the storage and maintenance of the tractor. The same applies to financing of business inventory. If the creditor must remain in possession of the inventory, the borrower is unable to sell this inventory and pay back the loan from the profit on the sale. Lenders will not release the property prior to full payment without some legal certainty that their rights are protected against third parties, and this requires more than changing the law. It requires a system in which third parties can be informed about the claims of creditors.[14]

Modern secured financing systems require credit-grantors to provide public notice regarding their claims on the debtor's property in order to have their interests protected. While compliance with such requirements provides credit-grantors with proper protection against fraudulent conduct of their borrowers, it also provides subsequent persons who deal with the property adequate means to learn about such pre-existing interests and protect themselves from claims on the property.[15]

These protections require a legal system that will recognize priorities in conflicting claims based on this form of public notice. The Armenian legal system does not have the necessary elements, providing only for public notice through possession. With computerization, modern registry systems can offer an efficient, reliable and affordable source to register claims of credit-grantors as well as to inquire about existing claims on a loan applicant's property. Credit-grantors interviewed in Armenia indicated that they are in favor of establishing such a system as a precondition to engaging in secured financing transactions.

b. State Claims

Another issue of particular concern is the fact that state claims in Armenia resulting from non-payment of the debtor's obligations to the state get priority even if they arise after the credit-grantor has complied with all the requirements the law imposes. Such claims include state claims for unpaid income or property taxes owed by the debtor.

In Armenia, some creditors indicated that they are willing to take the risk of losing their rights to state claims and that usually they do not require the borrower to show that they can meet their tax liabilities as a condition for credit. The explanation behind this is that the state is considered unlikely to enforce its claims against tax evaders. Borrowers who present to creditors balance sheets indicating higher assets/liabilities ratio are usually considered more creditworthy. Consequently, a practice has developed in this country where borrowers are unintentionally encouraged *not* to meet their liabilities to the state in order to improve their financial records in

14 Some financial institutions mentioned the practice of registering their rights with the traffic police. It appears that there is no legal basis for this practice. Therefore, there are no assurances that in case of conflict with a person with subsequent rights in the vehicle the registering person would have priority. Further, the traffic police register only vehicles.

15 Of course, it is important to have in such systems consideration for buyers of property that they purchase from businesses in the ordinary course of business. It makes no sense to require a person to check the registry before purchasing a product from the shelf of a business. See later discussion of Proceeds Collateral.

the eyes of the credit-grantors. This practice has a negative effect not only on the revenue of the state but also on the general practice of lending.

There is no doubt that, if a modern system of secured financing is to be developed, this shortcoming in the Armenian legislation needs to be addressed. In other countries, financing systems provide protections to creditors against unexpected state claims without undercutting state interests. For example, one jurisdiction requires the state to register its tax claims in order to obtain priority against interests by lenders who provide secured financing after the state has registered its claims. This way the state provides a simple public notice of its claim and creditors who receive public notice are more cautious about granting credit. On the other hand, credit-grantors that provide public notice before the state does have priority regarding their rights. Finally, experience shows that borrowers are more willing to meet their obligations to the state as credit is usually granted only in the absence of state claims against them.

c. Enforcement of unpaid loans – the Code of Civil Procedure and the Law on Compulsory Enforcement of Court Decrees

Successful secured financing must enable the credit-grantor not only to substantiate rights through public notice but and protect them but also to enforce those rights in the event of non-payment. The right of the credit-grantor to seize the property of the debtor and repay the loan is the "asset" of asset-based financing; it is the security of such transaction. For movable property, this ability to seize and sell is even more important because movable property usually depreciates in value over time, or can be improperly moved to another jurisdiction where the credit-grantor may lose his rights in this property.

The Armenian legal system does not contain adequate mechanisms to efficiently enforce claims of creditors on movable property. The rules contained in the *Civil Procedure Code* and the *Law of Compulsory Enforcement of Court Decrees* are not adequate to permit expeditious enforcement of defaulted loan agreements involving movable property. It is clear that asset-based financing in Armenia will be commercially viable only if courts will recognize these special agreements and grant orders allowing property used as security to be seized and sold in much shorter periods of time than are currently specified in these two laws.

Later in this report, there is a discussion about the enforcement agencies in Armenia. Almost all the interviewers indicated that one of the major obstacles for the development of the Armenian credit market is the inefficiency of these agencies in performing their duties. In addition to improving enforcement operations, changes in the legal framework can also improve the availability of credit by ensuring that the creditor is able to both repossess and sell the property. International experience has shown that proceeds are higher and delays often lower when creditors are permitted to control the sale process instead of state officials. The creditor is in the best position to obtain a higher price for the property, and this also protects the interests of the debtor. State auctioneers do not have the same incentives, leading to lower returns while being more susceptible to corruption. Sale by the creditor has proven to be the most commercially reasonable approach, but this practice is not currently available in Armenia. Although the law does provide for this possibility in some instances, it is not available in practice. Both the law and the practice need to be reformed.

d. Other legislative issues

i. Ease of drafting loan agreements

The drafting of a loan agreement is mentioned under Article 234 of the *Civil Code*. Under this provision, there is no requirement for such an agreement to be notarized. This feature of the Armenian legal system is very positive. Notarizing involves unnecessary costs and delays for many commercial transactions and is simply not required in a secured financing system. Armenian law has properly eliminated this requirement.

ii. Proceeds collateral

One of important features of modern secured financing laws is the ability of secured creditors to have their rights carried over from the original property used to secure their loan to the new property received in exchange. For example, a wholesaler may provide inventory as security for a loan. Any money received from the sale of the inventory is known as "proceeds collateral" of the original inventory, and the creditor's rights attach to it. This permits the wholesaler to operate a normal business (without subjecting the buyers to claims against the merchandise) while protecting the lender's rights at the time of sale.

Modern secured financing systems use proceeds collateral to replace the security while maintaining the flow of commercial transactions. The money the seller received from the buyer of the inventory becomes the new security of the loan. The same applies when, for example, the proceeds collateral is not money but barter – the creditor's rights attach to the new goods received for the inventory.

Article 259 of the Civil *Code* recognizes the concept of goods in commerce, establishing the right of a person who purchases property from a business to obtain good title to this property. This is essential if commerce is to function effectively. What is missing in the Armenian system is any provision that permits a security interest to continue in the proceeds from the sale of the collateral.

According to at least one financial institution in Armenia, the fact that the Armenian law does not offer assurances regarding the continuity of the interest of creditors on collateral is another major reason why business financing is unavailable in this country.

iii. Bankruptcy law

Often it is said that secured financing and bankruptcy are two laws of one system. They both involve debtor-creditor relationship. As mentioned above, credit-grantors are more likely to provide credit when they can predict the value of their rights in case they have to realize them. This logic extends as well to situations where the debtor becomes bankrupt.

Bankruptcy is an area of the law designed to assist debtors who are hopelessly unable to meet their obligations to discharge and be released from their liabilities. In most cases not all the liabilities will be met because they normally exceed the assets of the bankrupt. If secured creditors are assured that their rights regarding the property used to secure their loan is protected

even during times when the debtor faces bankruptcy, they are more likely to provide credit on favorable terms. If, on the other hand, they may lose their rights to the property because either these rights are not recognized during bankruptcy proceedings, or because of long and costly bankruptcy procedures, they are likely to refrain from providing credit. For this reason it is important to ensure that the rights of secured creditors in Armenia are not sacrificed during bankruptcy proceedings. This is not currently the case.

e. Leasing Law

Leasing is a specialized financing device used throughout the world. It plays an important part in expanding the pool of credit sources to business, manufacturing, agriculture and consumer sectors. What makes leasing attractive is the simplicity of the transaction and the greater security it offers to the lessor in relation to other creditors.[16]

Leasing has several unique characteristics that make it an efficient tool of financing. Under a lease agreement the lessor remains the owner of the property, which is similar to the claim of creditor under a secured loan transaction, but stronger. The lessor in fact rents the property to the lessee and in the event of default by the lessee can recover the property.

In many cases a lease arrangement is a financing device designed to facilitate the acquisition of property. Under some leasing arrangements, like financial leases, three parties are involved: the lessee or the person who is interested in acquiring the property, the supplier of the goods, and the financial institution that is the lessor. The financing that is provided is "secured" through the use of the lease. The financing party has the right to recover the leased property from the lessee in case of default. Leasing may also offer other benefits: it may provide some tax breaks, and it is subject to the close regulation of the banking system. (Indeed, at this point there is possibility that leasing will be over-regulated by the banking system, being subject to the same rules as institutions taking deposits. Since this assessment, however, a new law has been drafted to address these and other issues.)

The *Civil Code* in Armenia contains several provisions dealing with leasing. (See Chapter 35 of the *Civil Code* and related provisions). While this system provides a mechanism for parties to engage in leasing agreements, it lacks some basic features without which it is unlikely that a significant number of leasing transactions will take place. One of major problems is the power of the lessee to dispose of the leased property to third parties with the result that third parties can get title clear of the lessor's pre-existing interest. Another problem is Article 37 of the *Law on Compulsory Enforcement of Courts Decrees*, which terminates the ordinary enforcement rights of lessors during bankruptcy proceedings. Clearly, these mechanisms must be changed if any significant level of leasing is to take place in Armenia.

Improving the Armenian leasing law will require amendment to major legislation such as the *Civil Code*, the *Code of Civil Procedure* and other legislation. It also requires the creation of a mechanism where third parties dealing with the leased property can discover the existence of

16 Lessors are treated as creditors since generally they have similar rights to other creditors. Both give a valuable asset (leased property in case of a lease and money in case of creditor) while receiving the return for the use of this asset over time. Both face risk of the user of the property granting rights to third parties.

claims on the property. These required changes are applicable not only to a leasing law system but are necessary as well in order to create a more comprehensive system of secured financing.

Finally, it is important to remember that leasing is only a partial solution for the development of a modern credit market, only one tool in a comprehensive system of modern financing. Leasing is designed to facilitate the acquisition of specifically identified large and durable equipment. While it is extremely useful for the business, manufacturing and the consumer sectors for the purchase of such equipment, it is not suitable for the development and expansion of existing and new businesses. A more suitable system for the existing and future needs of Armenia should include a legal regime that allows growth of these sectors through the use of credit provided not only for the purchase of large and durable equipment but also to pay running costs of businesses, such as salaries to employees and liabilities to the state. While all the respondents expressed a great deal of interest in the leasing system, they also recognized the limitations of such a system for future development of the Armenian credit market.

Changing a legal system and, in particular, legislation such as the *Civil Code* and *Code of Civil Procedure* is always painful and politically sensitive. Leasing law and a more comprehensive secured financing system both require similar changes. It could be difficult to generate the wide political support needed for changes to the Armenian Codes (likely more than 50% of the total parliament) in order to adopt reforms for leasing law and then duplicate this effort later to adopt the additional provisions needed for a full system of secured financing. While leasing law may offer an excellent tool for specialized financing (see above), it does not provide the long-term solution to other kinds of commercial transactions that evolve with the development of the economy. Further, the demand for leasing in Armenia is based primarily on a planned project designed to create one company with capital of $1 million. If political considerations require a two-step approach, it should be clear to all involved that the leasing aspects are only one step in a more comprehensive reform program, which will provide for a significant subset of financing needs

3. Implementing Institutions

If Armenia is to enjoy the benefits of a modern secured financing system it needs more than proper legal infrastructure. The laws must be implemented and enforced. Legal reform programs have often been hampered when well-drafted laws were not supported by capacity among the agencies in charge of implementing the changes.[17] Implementation of modern systems of secured financing involves two major implementing institutions: a registry office for registrations of creditors' claims and the court system.

a. The Office of Registration

[17] In one country, the legal framework for bankruptcy was adopted in 1995. Six years later, there are still no cases of bankruptcy in that jurisdiction despite many de facto bankruptcies. Despite an adequate law, the judiciary – the principle implementing institution – has unable to deal with this new legal regime for lack of knowledge, understanding, and practical training.

Armenia does not have an office for registration of claims on movable property because there is no legal basis for recognizing or registering a non-possessory pledge. According to the Armenian legal system, the only way to provide public notice regarding the existence of claims on movable property of persons is through possession of the property by the creditor.

In mature modern credit markets, the registry system is the most visible and important part of a secured financing system. With computerization, registries are efficient and infuse a high degree of credibility, predictability and formality into the system at a very reasonable cost, without significant delays in the completion of the financial transaction. A registry system, if properly designed, can increase significantly the repayment rate of loans. A properly functioning registry has the effect of avoiding court procedures in many cases as it provides clear and useful information regarding the creditworthiness of debtors and about pre-existing liens on a debtor's property.[18] It also provides easy means for judges to resolve priority disputes between several creditors. As such, registries play a central role in stimulating the credit market.

Creation of a new registry involves several aspects. First, it is important to identify the government agency most suitable to be in charge of it.[19] (In a few jurisdictions, private sector entities run the registry.)[20] It is also important to develop a set of regulations for the proper functioning of the registry.[21] A crucial component is the development of software. If properly designed, computer software can offer an efficient tool to improve the level of services of the registry. It is particularly important in order to decrease human error and provide for centralized record searches instead of simultaneous physical searches in remote locations. Finally, a registry needs highly qualified staff to support its operation. This further requires training and the production of manuals for staff members.

Although, as mentioned earlier, there is no registry office for claims against movable property in Armenia, interviews and visits to various registry offices suggest that there is an existing foundation for such a system. First, financial institutions already use informal means to provide public notice of their claims despite the fact that such acts do not grant them any enforceable legal right.[22] Second, the company and land registries operate efficiently and registrations are done in a proficient manner, showing that the human and technical resources already exist for a pledge registry.

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18 Typically, movable property of high value and which is likely to change ownership is registered under the serial number of the property. This way it is easy to trace back the history of dealing with this specific property.

19 In many jurisdictions, the Ministry of Finance or Ministry of Justice oversees or even operates the registry.

20 This option must be carefully considered. It is usually not recommended to leave the control of the registry office with the private sector because the registry should not be a for-profit organization.

21 The regulations are of particular importance as they define many of the important aspects of the process of registration. They also provide the fees of using the office's services and staffing.

22 The registration of claims against vehicles with the traffic police is very common. This is done under the assumption that persons who are interested in purchasing vehicles would refrain from purchasing vehicles against which registrations exist. While this may be the case, there is no provision in the law that clearly grants security to creditors under such circumstances.

Perhaps the most impressive was the office of land registry in Armenia. Since its establishment in 1997, over 2500 registrations were made representing all types of rights on land. This central office in Yerevan has a highly qualified staff including an IT section, which took a leading role in developing the ownership registration part of the new software used in the office.[23] The staff of this office is deeply familiar with the characteristics of modern registries and the significance of properly organized and functional registry.

In sum, there is a strong foundation for creating a modern and efficient registration office of claims on movable property in Armenia within a short time frame.[24]

b. The Armenian Court System

As covered more fully elsewhere in this report, Armenia has recently created a system of commercial courts to handle commercial claims, such as non-payment of commercial loans. This is supported by enforcement agents – bailiffs – who are in charge of enforcing judgments, including the repossession of property. Although the commercial courts are too new to evaluate for effectiveness, the courts and bailiff system are dysfunctional. (Bailiffs are discussed in the next section.)

In addition to other problems, secured financing is a completely new concept in Armenia, and judges have no knowledge of such laws or experience in interpreting or enforcing them. Use of secured financing by lenders depends greatly on their level of confidence in the enforcement system, even though generally less than 1% of secured transactions ever end up in court. If judges are seen as being able to apply the law properly and based on the merits of the facts in front of them, predictability of the system is maintained with the result that creditors are more likely to engage in commercial transactions.

Experience shows that the first few cases in front of the courts play a central role in shaping the perception of the judiciary in the eyes of users of the system. For this reason is it extremely important that Armenian judges, and in particular those who deal with commercial cases, are fully familiar with the new system at the time the system comes into force.

23 The other part of the system, the mapping of the land, was developed outside Armenia. However, for the purpose of registry of movable property claims what is relevant is the ability to register such claims. Such system is very similar to the ownership registration system currently used by this office.

24 It is very important to realize that the office of the registry must be in a position to register claims and perform searches of its database on the first date of operation of the legal system. Experience in other jurisdictions suggests that the preparatory work on the registry system should commence at an early stage.

4. Supporting Institutions

a. The Execution Office

The services provided by the enforcement agencies are the last and one of the most important components of modern secured financing systems. As mentioned earlier, the ability to seize and dispose of the property is the real security a credit grantor seeks. If this process extends over several months and requires additional costs, which are not reasonable, creditors' rights will be seriously compromised. This is particularly true for movable and perishable property.

Numerous respondents complained about the capacity and willingness of the bailiffs to enforce judgments generally, even against properly identified real property. This breakdown in enforcement is reflected in Central Bank regulations, which do not provide for any reduction in reserve requirements for secured loans. On the contrary, they provide that secured loans must be collateralized *at least* 100%.

A second level of problems besets the enforcement system. When they do attach property, bailiffs have established a monopoly over the sale of assets, and do not use effective, market-based pricing mechanisms for the sales. This results in lower levels of collection than could be obtained through sale by creditors or through better market-oriented procedures. Not only are creditors damaged by this – through reduced recovery – but debtors are prejudiced because their debts are not being properly liquidated, leaving them unnecessarily indebted for the difference in the loan and the amount recovered through sale of assets.

As mentioned earlier, almost all the creditors expressed interest in having a leasing system. Because lessors are in fact the owners of the leased property, many legal systems allow them to repossess their property directly, or through expedited procedures. This right may exist theoretically in Armenia, but as a practical matter, once a debtor objects to repossession, the court must become involved, thus sabotaging the perceived advantages. This places execution back in the hands of bailiffs, who are widely perceived to be both ineffective and corrupt. Consequently, any improvements in the legal regime – either through comprehensive reform or simply the addition of leasing rights – must be accompanied by reform of the enforcement system.

It should be noted that problems of execution are not universal. Respondents involved in rural microcredit noted that they were able to enforce claims against movable and immovable pledge assets through the local court system. These success stories were based on three factors: simple legal claims that the courts could understand; persistent prosecution of the claims in the courts where the property was located; and the small town, "intimate" culture in which public knowledge and peer pressure play a key role in enforcing obligations. In the anonymous environments of cities, it is essential that enforcement be based on the rule of law, not relationships among the players.

b. Professional Associations

There is very little experience in Armenia with professional associations dealing with movable property as security for loans. One of the reasons is the very limited number of types of movable property that are acceptable to secure loans. In most cases in Armenia it is only gold or real property that is acceptable for security. As a result it is likely that accountants in Armenia are not familiar with the necessary criteria in order to evaluate other kinds of property. However, it is also clear that there is good capacity among the credit officers of the banks to adapt to a new system, which could require more elaborate process of evaluating credit worthiness of different kinds of property and debtors. What is necessary is a mechanism whereby they will be able to learn about the new system as well about their role.

It appears that the legal community in general and lawyers' associations in particular are unfamiliar with the operations and potential role of secured financing law in Armenia. There is currently no organization that directly deals with increasing public awareness regarding the credit needs of the country or possible solutions to those needs. This is often the role of various business associations, including banking associations and agricultural cooperatives, but this role has not yet been fulfilled in Armenia. A number of lawyers and other institutions do provide services on commercial activities, but when it comes to credit transactions, in most cases both creditors and debtors prefer to rely on their own staff. It is clear that when a more comprehensive credit system is in place, lawyers must be in a position to provide the necessary professional advise to those who seek to use credit. This kind of capacity can be acquired only with a more active Bar Association having some of its activities focusing on this area of the law and a system of continuing legal education to help the Bar and judges absorb and adopt the legal changes.[25]

c. Specialized Services

In some countries where there is a high volume of secured transactions, filing and record searching services appear and operate competitively to improve the cost and speed of transactions. Armenia will not need such services for the foreseeable future, as lenders and lawyers will tend to take care of all such transactions in the early years.

Other services are needed, however. First, a number of respondents noted that loan officers and risk analysts are in short supply and are generally poorly trained in evaluating commercial credit risks. Although secured financing may provide for some recovery in the event of default, lenders do prefer to avoid default, and thus make secured loans based on business plans, balance sheets and cash flow statements that reflect a reasonable ability to pay. They do not provide credit simply on the basis of the liquidation value of the secured property. However, few credit providers have a sufficient understanding of either risk assessment or property valuation, and thus cannot manage risks at the level needed to bring down the cost of money even with security. Assistance will be needed to upgrade the level of these individuals for any legal reforms to be

[25] In a number of jurisdictions Bar Associations have a specialized branch to deal with commercial law and sometimes this branch focuses on secured financing and bankruptcy areas.

meaningful, and the Armenian Bankers' Association could be a possible vehicle for providing the needed training.

In addition to specialized training institutions, universities and law schools need to include secured financing subjects in their curriculum. Until now, this has not been necessary because no such system existed. Once reforms are adopted, however, this will become crucial for the long-term health and development of the system. The existing schools – including state and private local institutions and the American University of Armenia – seem quite capable of taking up this role, but may need help in establishing an appropriate curriculum. As noted previously, continuing legal education is essential, as is ongoing education for bankers, leasing companies and others. This type of training is more likely to be provided through professional associations or specialized training institutes.

Computer services are also important for a proper electronic registry, and in this arena Armenia is already very strong. The real property registry is well designed, and human resources are available locally to do the bulk of the design and implementation of a movable property registry.[26]

The growth of computerized registration systems will provide the basis eventually for credit rating services. Currently, there are no such specialized services. Additional legal changes may be needed, however, such as laws on privacy, before a meaningful credit-rating system can be established.

5. The Market for a Modern Secured Financing System in Armenia

When assessing the market for legal reform it is important to distinguish between need and demand. While needs arise as a result of economic realities (and can be expressed as demand), demand depends on understanding of how the needs can be met. Once the business and professional communities, as well as the general public, recognize that their need for finance can be met through a system of secured financing, the need matures into demand for reform. As mentioned earlier, in Armenia there is a great deal of need for a more active and modern credit market so to allow expansion of this country's economy. Focused demand is still low, but certainly exists in the legal and banking sector. Indeed, once secured financing was explained to some respondents, they immediately expressed demand for these financing vehicles.

[26] The registry should certainly be computerized, but the law should only permit and not require this. Sometimes manual systems are necessary during transition periods or computer breakdowns, and manual entries should be legally allowable, especially if there is likely to be any lag in the implementation of the computerized registry. One Balkan country adopted a modern secured transactions law several years ago, which required a computerized registry. The registry took almost a year to install, so that the new system could not even be used until the computers were running, despite the fact that computerized registries have only existed for a few years as an alternative to manual systems.

a. The Market for Improved Secured Financing Laws

There is a great deal of demand for a better credit system among the Armenian business and banking circles. This is a result of the understanding that the Armenian economy is unlikely to expand with the current credit conditions. When the advantages of modern secured financing tools were brought to the attention of some of the interested parties, there was almost a unanimous response that these are vital.[27] Bankers who demonstrated how they lost their rights because of the weak legal structure pertaining to credit transactions expressed support for initiatives to reform the legal framework.[28]

The demand for changes in the legislation is weaker among government circles. One of the reasons being that any amendment to the legislation is primarily the responsibility of the Government. However, it is also clear that there is very little lobbying regarding the advantages such a system could offer.

One of the important characteristics of modern secured financing systems is that the benefits come with a carefully drafted and often detailed set of legal provisions. This is needed in order to avoid gaps in the system. However, in order to gain support among Armenian Government circles for reform to the law, it may be wise to start with a simple and short set of provisions that will address the demand and needs in the immediate future. This is possible, if there is understanding that the more complex of issues will indeed be addressed later when the Armenian market will become more diverse and sophisticated.

Although there were rumors of resistance to the adoption of secured financing laws in one of the key ministries, the "resistance" turned out to be based only on misunderstanding and lack of information, not on any disagreement with the proposed system. The respondent involved was concerned with "revolutionary change" in an environment that has undergone a large number of legal revisions in the past few years. These concerns appear to have been alleviated following the explanation that the new laws are meant to supplement the existing system rather than replace it.

b. Market for Implementing Institutions

In the past few months, USAID and European private interests have become very involved in working with Armenia to create a system that would support leasing. After the completion of the assessment, USAID has sponsored support for adoption of a registry system. This support should complement the strong existing interest in the business and banking community for this office. Demand is evidenced in the existing practice of lenders in providing public notice regarding security interests, despite the fact that this does not give them special rights according to the law. Interview respondents believed that the establishment of a registry office recognized

[27] Almost all the respondents interviewed expressed a great deal of interest regarding the idea of new leasing and secured financing laws for Armenia. Several also indicated they would like to see a change in the near future and suggested that the first step could be the *Leasing Law* part. However, they indicated something more than leasing is necessary to allow more credit opportunities.

[28] Thus, several organizations, for the most part international ones, expressed strong support for the proposed *Leasing Law*. Others expressed similar interest in a new registry.

by the legal system would be an important factor that will reduce significantly the risk associated with credit transactions.

Based on the experience of the land registry, where creditors register their interest in land as security for loans, and on the recent reforms of the company registry, Armenia seems quite capable of supplying a movable property registry utilizing, for the most part, local human resources.

c. Market for Supporting Institutions

As was mentioned earlier, the significance of supporting institutions in the context of modern secured financing systems is important with respect to the execution office, Bar Association, support for registry services and the academic community.

There is a great deal of demand to see the office of the execution office improved. There is however much less initiative taken by the end users to advance this interest. From the interviews conducted a clear picture emerges that reform to this institution is highly important, as it will introduce new and positive incentives to creditors engaging in lending activities. Further, an efficient execution office not only protects the rights of creditors, but not less importantly, it also creates an incentive to borrowers to perform their obligations so as to avoid having their property seized.

Support for a specialized Bar Association was also mentioned among some of the interviewers. This was in response to the fact that secured financing law is a specialized and new area. However, experience in other jurisdictions suggests that although a Bar Association that is specialized in this area of the law may have positive effect, it is not vital for the proper functioning of such system.

It is much too early to assess the demand for supporting services of the kind needed for the proper functioning of the registry system. As mentioned earlier, such services are useful in the context of other registries in Armenia but may be less significant depending on the type of claims on movable property that will gradually develop in this country. Thus, in a registry that allows registrations to be submitted by mail, fax, or through the use of a computerized network system, a procedure to accept requests in person is less important. However, since in some cases people may prefer to use the registry services in person, it may be useful to have branches of the registry in different locations in the country to provide the possibility of registering in person to those who are located in remote areas.

The need to develop capacity in the legal community to effect registrations on behalf of creditors or persons who wish to inquire about the status of property is not vital for the proper operation of a modern registry. Experience shows that because of the simplicity involved in registering claims creditors are able and prefer to register their claims on their own. This practice avoids undue costs and delays. Further, a good registry operation would also have sufficient structure to

interact with users at least during the initial period of operation so as to allow a smooth flow of information for making valid registrations.[29]

Finally, some respondents, including law students as well as other members of the legal community expressed their wish that the academic institutions will take a more active role in preparing lawyers to deal with more advanced and complex commercial law issues, in general, and credit transactions, in particular. In addition, since there is very little literature about the existing legal system in general in this country, a demand for more written material was also mentioned. As mentioned earlier, these kinds of supporting activities play a particularly important role in countries with a civil law tradition like Armenia.[30]

[29] A bad example is the recent registry system established in Kosova. Under that system creditors have no written material to learn about how to submit a valid registration, the system is on line almost from its first day of operation; the registry staff is not trained and the computerized system is not designed to spot mistakes that could make the registration invalid. As a result it is likely that many registrations that will be made in this jurisdiction will not be in accordance with the law and therefore would create serious risk to creditors without their knowledge.

[30] Within civil law systems, courts are not bound by the decisions of other courts unless the decision comes from an upper level court within the system.

C. Company Law

1. Legal Framework

The new 1998 *Civil Code* that came into force on January 1, 1999 establishes these legal forms of business:

- Entrepreneurial person;
- General and limited business partnerships;
- Limited (and additional) liability companies; and
- Joint stock companies.

The *Law on Entrepreneurial Persons*, the *Law on Limited Liability Companies*, and the *Law on Joint Stock Companies*, all enacted in 2001, complement the *Civil Code* provisions.

An "entrepreneurial person," similar to the Western sole proprietorship, enjoys many of the rights of a legal entity such as its own seal, business name and bank account.

Armenian partnership is not a widely used business form. General partners conduct business in the name of the partnership and bear liability for its obligations while limited partners bear risk of loss up to their contributions and do not take part in the business.

The limited liability company ("LLC"), the most frequently used business vehicle in Armenia, is a company founded by one or more persons who bear the risk of loss to the extent of their committed contributions. The charter capital of the LLC is divided into participation interests as declared in the charter. They share profits according to their investment ratio, unless another formula is stated in the charter.

The joint stock company ("JSC") is a legal entity that issues shares in order to raise capital for its activities. Shareholders of a JSC are not liable for the obligations of the JSC and bear the risk of loss only up to the value of their individual shareholdings. At the time a JSC is formed, the founders must elect whether it will be open or closed. In a closed JSC, the shareholders (limited by law to fifty) have a preemptive right to acquire the shares of other shareholders. The shareholders in an open JSC can dispose of their shares without the consent of other shareholders.

The new *Law on Joint Stock Companies* is better than the 1996 law it replaces. Inconsistencies with the 1999 *Civil Code* and ambiguities were cleared up. Substantively, the JSC law creates a framework for private sector companies that is familiar to western investors and lawyers. Shareholders have the right to participate in annual meetings, in person or by proxy, to nominate and vote for directors, using cumulative voting, to participate in profits in the form of dividends, and to assert claims upon liquidation of the company. Fiduciary duties are imposed upon the company's officers and directors, and the law requires an external independent auditor to review

and approve the company's annual financial statements. Company charters and bylaws are legally enforceable.

Nonetheless, the new JSC Law missed an opportunity to set forth an effective corporate governance system defining the rights and duties of shareholders, directors, and company management. The law imposes limitations that complicate corporate transactions without creating meaningful protections for shareholders and others. There are too many arbitrary lines that cannot be crossed. There is no *de minimis* rule. The "business judgment rule" which protects management in the United States when actions reasonably taken in the best interests of a company result in loss does not exist in Armenia. Other examples of arbitrary lines that cannot be crossed are the limitations on the total nominal value of preferred shares and bonds of a company, and the prohibition of debt-to-equity swaps. The law fails to specify mechanisms for the enforcement of creditor rights and protection of shareholders, particularly minority shareholders.

The ironclad distinction between "open" and "closed" joint stock companies is hard for foreign investors to understand. To take the most obvious example, if the number of shareholders of a JSC increases from 49 to 50, then under the JSC Law the company must be re-organized or liquidated. Reorganization under Armenian law is a complicated process with company management, shareholders, employees, creditors, the state, and even the community at large being involved in the process. This rigidity is not found in the company law or corporate practice of other developed countries.

Several respondents also commented that the law on open JSCs was too burdensome for the current context, noting that many public companies are now going private because they cannot reasonably comply with the new legal requirements. One local lawyer concluded that it was a good law, just ten years too early. Respondents felt that the new law would decrease the number of public companies in Armenia generally.

Although not strictly part of the company law legal framework, licensing requirements are an important part of the picture. In the past, Armenian legislation established an extensive list of investment activities requiring licenses and permits, but a new *Law on Licensing* was enacted on June 27, 2001. The law defines the types of activities subject to licensing, establishes uniform standards for all licenses (except energy and securities), substantially reduces the economic areas subject to licensing, simplifies licensing procedures, and provides for appeal in the event of denial of license. The licensing process is now more transparent and less discriminatory and discretionary.

Although far from perfect, the legal framework for company law in Armenia has improved substantially in recent years.

2. Implementing Institutions

Until this past year a major company law problem in Armenia was the complexity, cost, and corruption involved in registering a new business. The registration process demanded a large number of documents, was centralized in Yerevan (causing hardship for those living far from the capital), and often took up to 45 days. The simple act of officially registering a business was a

slow, complicated multi-stage operation, ranging from an annoyance for well-funded firms and influential investors to a disincentive, if not an outright bar, for small entrepreneurs struggling to gain entry to the marketplace.

After years of mounting complaints from domestic and foreign business groups, combined with pressure from international donors, the Government acted. Under the *Law on the State Registration of Legal Entities* adopted by the National Assembly on April 3, 2001 and signed by the President on April 26, 2001, the registration process was simplified, speeded up, and decentralized. Company registration was entrusted to forty-eight registration offices dotted throughout the country operating under the jurisdiction of the Ministry of Justice.[31] The costs for registering a company are extremely reasonable: about $18 to register an LLC and $8 to register the firm name.

Under article 21 of the *Law on the State Registration of Legal Entities*, the documents needed to register a company were standardized to consist of:

- An application of the founders of the legal entity.
- The protocol of the organizational meeting for the legal entity.
- Two copies of the charter approved by the meeting.
- The receipt for payment of the State registration fee.
- If one of the founders of the JSC or participants in an LLC is a foreign legal entity, a certificate of registration/good standing from its place of registration.

If the legal entity uses sample documents (application, protocol of meeting, and charter) provided by the state registry with the blanks filled in, then under article 16 of the law, the registry must act within two days on the application. If the charter and registration documents are specially prepared, the time limit for acting on the registration is five days.

Should the authorities refuse state registration of a legal entity (an extremely rare occurrence), the reasons for the refusal must be stated in writing and signed by the head of the registration office. Article 16 limits the circumstances justifying refusal of registration, and the vague standard of "inappropriateness" is not one of them. An aggrieved party has a right of appeal if registration is refused.

After state registration is completed, the legal entity must complete additional post-registration requirements such as obtaining a tax identification number, registering with the social security office, and obtaining a statistics ID number. (The company seal prepared before the company starts business usually lists all these numbers.) Over time, these additional processes can be computerized through a system of networked databases.

31 Armenia should be commended for establishing the registries outside the courts. Most transition countries – especially in Southern and Eastern Europe – are suffering from unnecessary court involvement in the registration process, including increased costs, slower processes, lower availability of judges for adjudicative matters, and higher numbers of backlogged registrations and other cases. In future reforms, Armenia should be careful to maintain the current regime.

Although the company registration process is much improved, there is one unnecessary step that cries out for elimination. This is the requirement that "before the state registration of a legal entity, the firm name of the legal entity shall be registered in the Patent Agency of the Republic of Armenia." This is mandated by amendments to the *Law on Firm Names* that took effect at the same time as the improvements to the company registration process. Although the law tries to minimize the delay and inconvenience to entrepreneurs by requiring that the firm name approval process take no more than two days, this is clearly an unnecessary step related more to the Patent Office's desire to retain this function than anything else. Because the Patent Agency is not decentralized, approval of firm names must be handled in Yerevan, working against the decentralization objectives of the recent reform. The Ministry of Justice hopes to modify the law and have the firm name approval handled as part of the registration process.

The company registration process is not computerized in the field but every ten days registration data are brought to Yerevan and entered on computers in the state registry. Six computers are linked in a LAN to share information among registry workers.

Since 1999 the Ministry of Justice has issued an annual report that summarizes new registrations of legal entities, reorganizations, and company liquidations during the year. The latest report (for year 2000) shows a steady increase in the number of new registrations. In 1995, the number of new LLCs was 7102; in 2000 new LLCs had increased to 21,738. LLCs account for nearly half of all new company registrations (44,196). By contrast, the numbers of new closed and open JSCs for the year 2000 are 3002 and 1189, respectively. It is premature to say precisely what effect streamlined registration procedures may have on new company formation. Officials at the state registry see an increase, but do not believe it will be dramatic.

The state registration offices under the jurisdiction of the Ministry of Justice are the first of two Implementing Institutions for Company Law. The second are the courts, discussed later in this report.

As of this writing, the economic court system is scarcely two months old so it is unclear whether the chronic problems in the courts, a subject of frequent complaint by lawyers, litigants, investors, businesspeople and the public generally, will be solved. The new JSC Law – and to a lesser extent the LLC Law - establish standards of corporate governance and protection of shareholder rights. Shareholders have the right to contest company decisions and board of directors resolutions in court, but to date the courts have not been considered effective in company law matters, particularly where the issues are complex.

3. Supporting Institutions

In the west accountants, lawyers, bankers, business associations, and more generally universities, foundations, and think tanks are key participants in the public policy dialogue that leads to improved company law, corporate governance, and the protection of the rights and interests of shareholders, directors, management, creditors, and employees. This support structure for company law is quite mixed for Armenia.

An NGO established in 1997, the Association of Accountants and Auditors of Armenia, has 700 members and seeks to develop the professionalism of accountancy in Armenia. A major objective is to assist members in meeting international auditing and accounting standards, an objective that, apart from the large international firms, still eludes most of the profession. Many accounting firms provide business advisory services for start-up firms and advice on the appropriate organizational form for a company – whether LLC, open or closed JSC etc. Demand for this service is growing. A second major area is the review and approval of a company's annual financial statements by an external auditor, as mandated by the new LLC and JSC laws.

The government's laissez-faire attitude to the licensing of lawyers in Armenia has not spurred specialized lawyers' associations dedicated to company law reform. In Armenia today anyone can become a lawyer. A person can form an LLC and hang out a shingle without having gone to law school as long as he does not appear in court or handle criminal cases. The Council of Europe to which Armenia has recently acceded is urging Armenia to establish a single, unified Bar,[32] but currently there are three Bar Associations competing for Armenia's 400-450 lawyers. One particular NGO, the Young Lawyers Association, appears to be more proactive in the company law area, and there are individual lawyers with corporate clients who have become active in urging reform of specific company law provisions.

In the west, the stock exchange is usually an effective avenue for company law reform. In Armenia there is one stock exchange, but there is little trading except for government bonds. When the 1998*Civil Code* became law in 1999, the earlier *Securities Law* was repealed, leaving only a few articles in the new code to deal with securities. In 2000 an extremely long and complex (100 pages, 157 articles) *Securities Market Regulation Law* was enacted. There are detailed provisions on the public trading of securities, registration of broker-dealers, and the operations of the Securities Commission. The regulatory body exists but, at present, there is little to regulate. As a supporting institution for company law, the stock exchange has barely started its work.

With the exception of the American Chamber of Commerce in Armenia which is extremely active in company law reform, no other chamber of commerce, banking, or business group can be said to be particularly active in this area. Nor, with the exception of the normal activities of Armenian law schools, are universities, foundations, or think tanks involved in company law to any significant degree.

The numerical scores that Armenia receives for Supporting Institutions in this area reflect the mixed picture described above.

4. The "Market" for Company Law Reform

[32] It is important to distinguish here between voluntary associations of lawyers, know in the West as "Bar Associations", and mandatory registration with a state or parastatal organization, generally known as "the Bar." Some countries have attempted to ensure appropriate regulation of the legal practice by mandating membership in a single organization – "the Bar" – and have eliminated all other associations of lawyers, creating an unnecessary monopoly. The result is usually a moribund, non-responsive monopoly organization that provides few meaningful services while keeping demand-based service organizations out of the market. Armenia will do well to avoid this mistake as it considers reforming the requirements for the practice of law.

Despite the mixed picture, there is no doubt that the supply of company law has improved. A few years ago the legal framework for company law was grossly deficient. Now the basic laws exist and the issue has shifted to whether standards of corporate governance can be effectively enforced in court.

Based upon the opinion of lawyers, bankers, businessmen, and business-related NGOs that the team interviewed, major problems associated with the state registration of companies have been corrected. One influential lawyer said company registration was now a "snap." Others said that a week, more or less, to register a company wasn't a big problem. Compared with the unfinished business in company law - i.e. corporate governance, enforcement - company registration concerns have receded in importance.

As to the demand for company law reform, there is no doubt that the reform constituency is growing. This is apparent from the attendance at the AmCham country competitiveness conferences and discussion on the e-governance documents that AmCham has generated. The business community still feels largely cut off from the legislative process. There is no established system for vetting with business groups draft legislation and draft governmental implementing regulations. Nor do business groups and lawyers have access to court decisions. Well-reasoned, objective, consistent, predictable decision-making is at the core of the rule of law. Armenia can do much more to give the business community a meaningful role to play in shaping policy reform in company law and in making the laws accessible, transparent and user-friendly.

D. Competition

1. Legal Framework

The *Law on Protection of Economic Competition* was adopted on November 6, 2000, as part of Armenia's legal reform process on the road to World Trade Organization accession. The aim of the law (article 1) is to protect and promote economic competition, to create an environment for fair competition, to help the development of entrepreneurship, and protect consumer rights. The substantive provisions of the law are based on sound economic principles though from a legal perspective, much of the language is loosely drafted. Although far from perfect, the law does offer a solid basis on which to build.

Some of major criticisms of the law identified by EU and US observers are the following:

- The article 5 definition of anti-competitive agreements as those that "might result" in an artificial increase, decrease, or maintenance of prices on the commodity market is vague. Article 5 could be much improved by an explicit distinction between horizontal and vertical agreements. In western countries many of these agreements are *per se* illegal if horizontal, but may be benign if vertical.

- Articles 6 and 7 would be improved if examples of abuse of dominant position were provided, if criteria other than market share were developed (such as adding a barrier-to-entry provision), and if new provisions extended the description of relevant market to include product and geographic markets.

- Relating to mergers and acquisitions, the concentration provisions in article 9 are obscure even in the Armenian language and the pre-merger notification requirement has an excessively low reporting threshold ($ 4 million) in terms of foreign investors.

- The unfair competition provisions in articles 11 to 16 cover misleading advertising, trademark issues and business torts. The risk exists that the competition commission (described below) could be deluged with a huge volume of consumer and competitor complaints on matters that are really private disputes and do not affect competition as such. To avoid this, the Law should be more explicit in not only permitting but also encouraging private civil suits to enforce rights under this part of the Law.

Starting with article 17, the Law creates the State Competition Commission as an independent agency of the Armenian government. Article 18 confers these main functions on the Commission:

- Considering cases of infringement of competition legislation and making decisions.
- Keeping a centralized register of economic entities with a dominant position.
- Developing state competition policy and participating in the elaboration of legal acts.
- Cooperating with foreign entities, NGOs, and international organizations.
- Publicizing its activities to inform the public of the benefits of increased competition.

Article 20 provides for a Commission of seven members including the Chairman, Deputy Chairman, and five members appointed by the President for staggered terms of five years. Article 22 authorizes the Commission to establish the number and structure of its staff.

Article 27 provides that the Commission shall submit to the National Assembly its annual program of activities by October 1 of each year and its annual report of activities for the prior year by May 1 of each year. Should the National Assembly at any time disapprove either the annual program or the annual report of the Commission, then all the members must tender their resignation to the President within ten days of such disapproval.

As of this writing, the Commission's implementing regulations have not been adopted. The Ministry of Justice has challenged the legality of these regulations on the ground that they exceed the legislative grant of authority to the Commission by the National Assembly. It is not sure whether the Commission will challenge this claim in court or comply with the Ministry's decision and re-draft the implementing regulations.

Armenia's post-privatization experience illustrates transition economies' difficulties in providing balanced government regulation of commercial activities and public utilities (or natural monopolies). Although a Public Utilities and an Energy Regulatory Commission have been proposed, legislative action has not yet been taken. A legal structure does not yet exist for identifying and regulating natural monopolies nor is there a specialized supervision agency for natural monopolies.

Armenia is also undergoing transition difficulties with the misuse of state enforcement powers in other areas of law that permit privileged businesses to gain an anti-competitive position. Respondents reported that customs and tax laws are enforced inequitably, with a few well-connected, dominant importers able to manipulate the system so that their competitors are subjected to higher scrutiny and more effective enforcement while they obtain inappropriate customs and tax reductions for themselves. This abuse of a dominant political and economic position has allowed the de facto creation of an import cartel for a number of staple products.

2. Implementing Institutions

The State Competition Commission was established on January 13, 2001, and all seven commissioners have been appointed. Space is being renovated for the Commission on two floors of a dilapidated government office building.

The Commission is not well funded. The budget authorizes a staff of forty, most of who have been hired. The Commission staff includes some excellent young economists, lawyers and technicians though, not surprisingly for a transition economy, without much experience in competition policy matters.

To date, the Commission's efforts have been directed to two substantive tasks. The first was meeting the requirements of article 27 of the law by preparing the annual program for the coming year. The program must contain an analysis of competition problems, a description of competition protection measures, and an implementation schedule for major sectors of the

economy that the Commission will work on. The annual report was submitted by the October 1 due date and it has been approved by the National Assembly.

The second task is the identification and registration of firms with a dominant position, defined under article 6 of the Law as firms with at least one-third of market share. The Commission's staff has been obtaining information from both public sector and private sector entities to ascertain which firms meet the one-third threshold. Compiling and maintaining a centralized register of companies with a dominant position is an enormous bureaucratic undertaking. Other transition economies have discovered that staff resources would be better spent investigating allegations of abuse rather than expending huge resources in cataloguing firms.

To date, no cases have been brought by the Commission. The investigative/enforcement talents of Commission staff are, as yet, untested.

Whether the Commission will eventually be able to play a leading role in the development of a strong competitive market economy in Armenia will depend on the answers to these questions:

- Will the Commission leadership develop a shared vision of its role and function?
- Will the Commission adopt a strategy that focuses on winning its first cases to show the public what it is able to accomplish?
- Will the Commission gain the support of other branches of government for its activities?
- Will Commission staff develop the skill and expertise to get the job done?
- Will judges, lawyers, the business community, and the general public gain an understanding of the benefits of increased competition and come to support the work of the Commission?

At the present it is not possible to predict the answers to these questions. Bringing competition policy agencies to the stage where they can operate effectively in transition economies is difficult, and Armenia has just started down that road. The Commission's mission and purpose are not widely understood even by those government entities with which it must collaborate.

One of the Commission's most important functions is public outreach. The Public Relations Division will publish a journal, issue press releases, assist members of the Commission with radio and television appearances, and publish brochures, all with the aim of informing the public about the benefits of competition. The Commission also plans to develop a web site.

One thing seems certain, though. These things will not happen on their own. Without substantial technical assistance and financial support, it is unlikely that the Commission will achieve the competition policy objectives set forth in the law.

3. Supporting Institutions

In the West, professional associations of economists, lawyers, bankers, accountants, business associations, and more generally universities, foundations, and think tanks are key participants in the public policy dialogue that leads to an improved environment for fair competition and the restriction of anti-competitive practices. This support structure for competition law is at an extremely early stage of development in Armenia.

In the public consciousness, fair competition and consumer protection come behind preserving domestic jobs even if it means keeping uneconomic plants in business. Few articles are published in the national media supporting market-oriented competition policy. Neither professional associations nor lawyers monitor anti-competitive practices to any significant degree or report suspected violations to the Commission. Chambers of commerce, banking, business groups, and NGOs cannot be said to be active in competition issues. Nor, with the exception of Armenian law schools (whose curriculums do include competition law), are universities, foundations, or think tanks involved in competition law to any significant degree.

Judges have had little training in competition law, and the courts hear few cases on competition law issues.

The numerical scores that Armenia receives for Supporting Institutions in this area reflect the low state of competition law development.

4. The Market for Competition Law Reform

Apart from a single mention in the *Civil Code* (article 12), the supply of competition laws was non-existent until the enactment of the *Law on Protection of Economic Competition* late in 2000. Despite deficiencies in the Law, it is a solid basis on which to build.

Although the present demand for competition law reform is weak, it will increase as the Competition Commission shows its effectiveness as a regulatory body and its usefulness as a catalyst for changing whatever pro-monopoly orientation may have carried over from Soviet times. Much depends upon the Commission's strategy in bringing (and winning) its first cases and the public's starting to see the benefits of increased competition. In time, this ascending spiral should lead to an improved supply of competition laws as defects in the law are remedied and gaps are filled.

The privatization and reorganization of firms in Armenia was expected to change the nature of the markets. In reality, it often amounted to nothing more than the replacement of a state monopoly by a private monopoly. If the Competition Commission were to move against monopolies for abuse of dominant position, such as ArmenTel, the Greek-owned telecoms provider would be a potential target, this might generate public enthusiasm and appreciation for the benefits of competition. ArmenTel's proposal for metering of local telephone calls, now subject to a sixty-day cooling-off period, is the kind of issue that could galvanize public opinion and move the Competition Commission from its current oblivion to center stage in public appreciation. Likewise, public understanding of the impact of import cartels on consumer prices is probably a pre-requisite for creating the demand and political will to break the existing cartel.

Presently, the business community is not a player in competition law reform. Competition law reforms are not vetted with the public, nor are draft laws or implementing regulations. Armenia should do more to give the business community a meaningful role to play and in making the laws accessible, transparent and user-friendly.

E. Contract

1. Overview

The formal framework of contract in Armenia – the 1998 *Civil Code* and ancillary laws – is quite well developed but is not well understood. Several legal specialists opined that virtually no one understands the new Code. There are some obvious gaps in related laws. In real property transactions, for example, the cadastre process of land registration and the law governing contracts for the sale of land are consistent, but laws permitting secured lending have yet to be developed. Labor contracts, too (although outside the direct scope of this report), present problems. Many respondents were critical of the formalism and inflexibility of Armenian labor law. The informality of labor contracts has a direct bearing on the protection of intellectual property in Armenia, since the employer-employee relationship is one in which know-how and other forms of intellectual property are typically developed and applied.

Due to problems including a lack of vehicles for secured lending, insufficient contract enforcement, labor contract inflexibility, and confusion about intellectual property rights there are parallel worlds of contract operating in Armenia. As one foreign businessperson states, "There is no contract in Armenia," by which he means that, despite the recent legal changes, almost all business transactions are done on a cash basis and contract informality (unwritten agreements) is the norm. Corruption is also a corrosive influence on contract in Armenia.

Without developing laws that allow secured lending, the growth of complex contractual transactions will be impaired. Secured lending is also an equity issue. One local lawyer explains it this way: "Eighty percent of our citizens are making contracts for credit, loans or collateral and no one understands what they are doing. This causes a great deal of trouble and [social] damage because of the lack of understanding and typically people come to a lawyer too late."

To the extent that laws support development of contract practice, there is pervasive lack of legal information or continuing legal education to enable practitioners to understand and take advantage of the numerous legal changes underway.

2. Legal Framework

The fundamental source of contract law in Armenia is the 1998 *Civil Code*. The scope of the of the *Civil Code* is remarkably broad; its 1292 provisions run to 358 pages and contain the general and special provisions governing contracts and capacity to contract; agency and contracts of work; special contracts such as insurance, factoring, franchising, etc.; commercial organizations and corporations; real property and intellectual property; tort and unjust enrichment; inheritance; and conflicts of law. Code drafting was carried out with the funding assistance from USAID and with technical legal assistance from U.S. and European legal advisors. The legal systems of Russia, Germany and the Netherlands provided reference points for the style and content of the Code and the drafters also considered neighboring legal systems such as Georgia.

a. Contract Formation

Like its counterparts in most civil law countries, the *Civil Code* defines the elements of an enforceable contract and the remedies available for breach. It allows parties freedom to choose both the form and content of their agreements, except insofar as the form is mandated by statute and provided that the contract does not conflict with "state and societal security, social order, the health and morals of society, the defense of the rights and freedoms, honor and good name of other persons." (Art 3(2)) The rules on formation allow for formation by electronic (including digital) means. Examples of contracts required to be in writing include: suretyship (Art. 376); loans (Art. 878); credit contracts (Art. 888) freight forwarding (Art. 872) franchises (Art. 970); insurance (Art. 996). Examples of those required to be notarized (and thus made in writing) include pledges (Art. 234); mortgages (Art. 263); sale of land or building (Art. 562); rent of land or buildings (Art. 572); lease of immovable or moveable property (Art. 610); lease of a building or structure (Art. 654); lease of a house (Art. 662); finance lease 8Art. 678); and entrustment of administration of property (Art. 959).

One effect of having such as broadly-framed *Civil Code* is that there is no bright-line distinction between commercial contracts and contracts involving non-merchants. In practice, the distinction seems to turn on the status of one or other parties i.e. where one or other party is an individual entrepreneur or a commercial organization. Individual entrepreneurs are defined under the *Law on Individual Entrepreneurs* 2001 as ' a physical person that has the right, independently, on his own behalf and at his own risk without forming a legal entity to implement activities the main purpose of which to gain profit (income) from using property, selling goods, performing works or delivering services (Art. 1). In the case of some specialized contracts e.g. franchises, the *Civil Code* explicitly restricts the formation of such contracts to 'commercial organizations and citizens registered as individual entrepreneurs' (Art. 969). In other cases, the nature of the contract may be a question of interpretation. This characterization is likely to be important in determining the jurisdiction of the new Economic Court (*Law Amending the Judiciary Law*, 2001) Article 1 of the *Law Amending and Supplementing Civil Procedure Code*, 2001 amends Art. 16 of the *Code of Civil Procedure*, to provide that "economic disputes" to be heard by the Economic Court are those "concerning citizens having the status of an individual entrepreneurs and with the participation of an entity which is a commercial organization …if they in their essence relate to the field of entrepreneurial activity". This is a very imprecise definition, but in practice is likely to be interpreted liberally in a way that builds the jurisdiction (and revenue base) of the new Court.

One of the important social institutions caught in the middle of this legal transition is the non-governmental organization (NGO). The *Civil Code* has only a couple of provisions regarding non-commercial organizations (arts 122-124) that are clearly aimed limiting the liability of religious organizations or clubs or small social organizations. Non-governmental organizations are different because they are not necessarily non-profit organizations. Up until 2001 non-governmental organizations in Armenia were treated as tax-exempt, but from 1 January 2002 were to be taxed as corporations. A new *Non-Governmental Organization Law* in draft is likely to mandate that NGOs wishing to engage in profit-generating activities should incorporate as companies (and contract under the *Civil Code* as corporations). The regulatory burden of operating as a corporation is likely to cripple NGOs, or result in a flurry of paper companies that report zero profit. Of the estimated 2000 NGOs in Armenia at present about half are inactive, in

part because of erratic funding. In principle, there is no reason why the *Civil Code* could not be amended to clarify the status of incorporated associations that are permitted to earn a profit, and whose tax-exempt status is determined by their charter. This assumes, however, a Tax Office that could offer impartial and consistent rulings.

In principle the *Civil Code* provides that the contractual rights and obligations of natural persons, domestic and foreign corporations and state-owned enterprises are similar. In practice they vary, as we discuss below. The state and its agencies are explicitly made subject to the *Civil Code* to the extent that they engage in *Civil Code* transactions.

The 1998 *Civil Code* requires notarization of a wide range of contracts. Notarization in Armenia is a substantive, rather than an evidentiary requirement. This means that the notarization (or lack of it) determines the validity and thus the enforceability of the contract. So, for example, a full cadastral record includes the certificate of ownership of the property; names of the buyer and seller; proofs of the parties' identities; and the revenue receipt for the notarization of the contact of sale. Problems have arisen in the transition from oral agreements to notarized contracts. For example the cadastre (land registry) now refuses to register transfers of real property unless evidenced by a notarized contract of sale, but this seems to be less than completely understood by parties in some transactions. A number of litigated cases are pending against the cadastre for non-registration of sales of land.

b. Interpretation and Freedom to Determine Content

The *Civil Code* explicitly recognizes customs of commerce (Art. 7) as an evidentiary source for determining how to interpret contracts, to the extent that these do not contradict the mandatory public policy provision of the legislation or explicit provisions of the contract in question. In practice it is not clear whether or how courts go about this kind of enquiry.

Contracting parties are free to agree on customized terms in their contracts, e.g. liquidated damages, choice of forum, choice of law and other remedies. In practice it is clear that some lawyers have experience drafting transnational agreements, and that the choice of foreign law as the governing law is not challenged. However, small and medium sized businesses are not investing in customized contract drafting. In at least one foreign-owned business, the practice with employment contracts is to hire staff by combining elements of Armenian labor law and an American standard-form employment agreement. It is unclear how an Armenian court would handle this is the case of dispute. A foreign lawyers we interviewed was forthright about this – in their view, since Armenian judges have to be educated about the law of Armenia, why not U.S. law or the law of another foreign jurisdiction?

Armenia is not currently a signatory to the Convention on the International Sale of Goods (CISG).

c. Remedies and Enforcement

The *Civil Code* in principle allows enforcement of all valid contracts by individuals, private entities and non-private enterprises, to the extent that the contract is not contrary to public policy (Art. 3) and does not involve an abuse of rights by one or other party (Art. 12). Procedural law and a new *Notaries Law* (in draft) support the implementation and enforcement of contract through the court system. The *Civil Code* provides for the usual contractual remedies, including liquidated damages (including penalty clauses), specific performance and money damages. As with most civil law systems, the payment of monetary damages does not necessarily relieve the party in breach of the obligation to perform the contract, unless this is provide for by contract (Art. 412). The measure for calculating money damages is clear in principle in the Code (Art. 17), but has only recently begun to be tested in the courts.

d. Implementing and Supporting Institution

In principle, the *Law on the Judicial System*; the *Law on the Status of Judges* 1998; the *Law Amending the Law on the Judiciary* 2001 which creates the Economic Court; the 1998 *Code of Civil Procedure* and the *Law on Compulsory Enforcement of Judicial Acts* together provide the key implementing and supporting institutions for contract in Armenia. In practice, the *Code of Civil Procedure* is not well suited to commercial cases, as discussed later in this report.

The scope of notaries' work is set out in part by the *Civil Code* list of documents that must be notarized to be valid as contracts, while the revised *Notary Law* (currently in draft) confirms the role of notaries, expands their operations to the provision of legal advice and rationalizes the basis for their fees. In fully implementing contract law in Armenia, much will depend on the operation of the new Economic Court, which is clearly intended to function as the primary implementing institution for contract and commercial transactions.

3. Implementing Institutions

a. Court Organization

In theory the *Law on the Judicial System*; the *Law on the Status of Judges* 1998; the *Law Amending the Law on the Judiciary* 2001 which creates the Economic Court; the *Code of Civil Procedure* and the *Law on Compulsory Enforcement of Judicial Acts* together provide the key implementing and supporting institutions for contract in Armenia. They clearly identify courts as the locus for contract enforcement and provide a clear mandate for the courts' jurisdiction (although this is in flux for the new economic court).

In practice the courts are deeply flawed as an institution. Courts appear to be under funded by the state and understaffed, while judges and court officials appear to be under-trained and underpaid. Judges do not themselves trust the quality of each other's decision-making and so, even if previous case decisions were accessible to the judiciary as a whole, it is not clear that judges would automatically develop a system of functional precedent. It is indicative that the Minister of Justice identifies civil procedure and revitalized judicial training as two of his current priorities. A new $11.4mWorld Bank project focused on judicial reform (including case

management, a database of judgments, physical infrastructure, bailiffs and public awareness) began a year ago and is scheduled to run 3-4 years. By itself it will provide the impetus for some system improvements but only in the short term and only within this framework.

b. Court Operations

Clearly courts are hearing contract disputes. We heard in interviews about several cases resolved in court, or currently pending. Cases involving challenges to the cadastre for refusing to register a transfer of land are also common. One lawyer explained the relatively high rate of litigation as a by-product of contractual ignorance: "Parties think it [the contract] is just paper – they don't see it as real provisions for the protection of rights".

c. Government Contracts and Administrative Decisions

We were not able to identify any independent structure that functions as an administrative tribunal designed for handling commercial disputes between government and the private sector. Paradoxically, the most controversial case involving the government and a private sector entity is the long-term contact signed by the government with ArmenTel, a Greek-owned telecoms provider. In part the contract is a concession for the company that guarantees it a long-term market monopoly. Critics of the contract charge that the government undervalued the market access that the contract allows, that its award probably involved corrupt payments and that the government is being dilatory in enforcing performance standards. ArmenTel's lawyers comment that, even coming from Greece, their client was surprised at the lack of commercial sophistication in Armenia. The client's view is that they are being harassed and that no one is looking at the big picture for foreign investment. Dissatisfaction with the quality of service provided and consumer protest against a planned move to timed calls are two issues that are widely discussed and publicized in Armenia at present. The venue for resolving these issues has not to date been the courts, but rather a kind of shuttle diplomacy by ArmenTel's lawyers to senior government offices.

4. Supporting Institutions

a. Government Entities

Despite the centrality of notaries to many everyday contract transactions in Armenia, the average person's access to a notary is less than optimal. Clients line up patiently for hours in very basic physical surroundings that lack computers, copiers and file management systems. Processing transactions is necessarily slow. There is a clear disconnect between the notaries' view that the *Civil Code* requires 'all transactions' to pass through them (it does not) and their capacity to delivery timely professional services.

The government directly controls the number of notaries in Armenia through a licensing system and an examination. We were told that there are currently 80-82 notaries in nationally 20 of who are in Yerevan (1 or 2 per district). Another 30 candidates have qualified as notaries but have not yet been appointed by the Minister of Justice. The largest notary office in Yerevan currently has five notaries, a *juris consultant* (a government employee who provides legal advice) and a

secretary. The average age of notaries is about 40-45 but younger notaries are typically assigned to the provinces, so that the average age of notaries in Yerevan is higher.

Legal education is mandatory for notaries, who must then complete a year of training under a senior notary, who then reports on the trainee's suitability to the Minister. Upon passing an exam administered by the Ministry of Justice, a notary is eligible for appointment. Respondents told us that most government examinations in Armenia are for sale, so it is unlikely that the notaries' examination at present is an instrument for professional development.

A new *Notary Law* (currently in draft) offers some support to notaries as a nascent profession. During the Soviet era notaries were simply post-retirement government employees with low prestige who formalized copies of documents. Now, most of their work is commercial transactions. At present it is clear that notaries also provide legal advice, particularly to those unable to afford lawyers. The new law formalizes that practice by attaching a fee to provision of legal advice. Notaries will remain state officials under the new law, but will move from a fixed salary to income that is based on the number of transactions processed. The new law requires notaries to retire at 65, just as judges are required to.

At the moment notaries' salaries are high relative to other state employees (e.g. three times or more the salary earned by a teacher). However, it is also clear that the salary alone is insufficient to operate a professional office. We infer that clients are paying more than the scheduled fee at present to facilitate transactions. Notaries expect that the ability to generate income directly will enable them to upgrade their office facilities and provide better quality of the service.

The formal fee structure is determined by the *Law on State Taxes* that fixes notarization fees. The charge is 10,000 drams for every approval of any kind of transaction. Wills and other documents are 5,000 drams. Approval of copies is 300 drams per page; approval of signature is 500 per page. There is no state tax for approval that exceeds 10,000 drams. For approving a right of inheritance of the first degree the fee is 3,000 drams and for second-degree 5,000 drams and relationships beyond that, 10,000 drams. Clients do not pay notaries directly, but pay the charges at the bank and then produce the receipt.

Professional development is a major challenge for notaries. The Notary Association reportedly engages in some ongoing education and circulates copies of new legislation. The Learning Center/Institute in the Ministry of Justice that provides training for judges also covers notaries. Our respondents seemed resistant to the suggestion that they may require more and more sophisticated legal training. We were told that notaries receive about a month per year each of training and that the Ministry's Center is sufficient for this. However, this is inconsistent with comments from lawyers and legal academics that their own and judges' understanding of the new *Civil Code* is inadequate. This suggests to us that the level of legal education and training for notaries may need reexamination.

Customs officials were identified as a major systemic drag on the development of contract in Armenia. Although a foreign advisor is currently working with Armenian Customs to lift its capacity, business perception at present is that the Customs Office lacks basic manpower and equipment to cope with routine applications for paperwork. Preparation of simple import and export documents can take several days. For freight forwarders the costs of demurrage on trucks

left idling for this period means that the payment of bribes becomes unavoidable because their clients are unwilling the bear the real financial costs of a barely functional customs office. At the border, harassment by customs officials is the norm e.g. demanding the complete unpacking of a truck laden with small parcels and threatening physical inspection of each parcel unless a "fine" is paid. Conversely, we were also told that tariff schedules are for sale and that in the case of new goods or foodstuffs being imported, the tariff rate is a matter of negotiation with Customs based on the projected profit and 'take' for the facilitating official(s) In a country that has no sea access and that is a net importer, these system costs are considerable.

Tax officials are also responsible for undermining contracts. In lending to small and medium sized business, for example, a USAID partner financial institution calculates the tax that will be levied illegally on the borrower's profits and adjusts their lending upwards. In all the foreign-invested businesses we interviewed, visits and harassment from the tax office were expected and regular. In freight forwarding road taxes improperly applied to the complete journey rather than the journey within Armenia's borders have been successfully challenged in court by one foreign-owned freight forwarder, but not by its domestic competitors.

b. Professional Associations

We need to be careful in describing the legal "profession" in Armenia. Although a profession exists in form (there are three Bar Associations in Yerevan, for example) in substance it is far removed from its counterparts in the developed world. Entry to the legal profession is not regulated and law graduates are not guaranteed work. We were told that the multiple choice exam for advocates is available for the equivalent of $25, so this hardly has a gate-keeping function. Younger lawyers and advocates within the associations aspire to a higher level of competence – some are engaged in informal legal education and training. However, there is no coordinated continuing legal education across the legal profession that delivers systematic training and updating on contract and commercial laws.

Local and international lawyers practicing in Yerevan told us that that have no direct input into law making, including the development of contract and commercial law. The picture in law schools is somewhat brighter: some law professors are clearly developing contract law courses that in content and scope are very similar to those offered elsewhere in market economies. Courses covered both domestic and international contracting as well as cross-border litigation involving contracts.

A major weakness in institutional support for contract law, however, is the near-total absence of treatises and explanatory writing about the 1998 *Civil Code*. One impediment to publishing is that "official" textbooks – those that can be used outside a single classroom and across the university system – require government permission. Another impediment is the pace of legal reform. In a situation in which legislation is literally changing daily and is difficult to track, the incentive to publish is diminished.

We were shown one treatise on the *Civil Code* published with financial assistance from USAID and one book of domestic contract forms edited by the former academic who chaired the Code drafting committee, which was apparently distributed to judges but is regarded as 'very

expensive'. Some professors have prepared teaching materials for the classroom on domestic and international contract, but have told us that they have neither the time nor the resources to develop these for publication. "Legal publishing is very difficult in Armenia," said one professor, and indeed the in-house publishing capacity of Yerevan State University's Law School is simply desktop copying. The Yerevan State University Law School publishes a law journal covering 'all legal topics' but we could not discern from our discussions any particular commitment or capacity to writing on contract and commercial law. Beyond the books mentioned we could not identify any continuing legal education materials for practitioners and no research or publication in progress likely to produce any.

c. Specialized Services

Commercial arbitration of the kind used for contract disputes seems unknown in Armenia at present. We could not identify any commercial arbitration services or commercial arbitrators available as alternatives to court adjudication of contracts. A new *Arbitration Law* is scheduled to go to Parliament soon and it will provide that arbitrators are lawyers. Arguably the largest commercial contract in the country, between the government and foreign-owned telecom provider ArmenTel provides for arbitration in London. This would theoretically be enforceable in Armenia under the New York Convention on the Enforcement of Foreign Arbitral Awards.

Publishing on contract for business users or the general public beyond the few books described above appears non-existent. The official gazette publishes only one thousand copies of new laws made available only in hard copy. The most successful legal publishing venture to date appears to be a private company that publishes a database of these statutes including those relating to contract and commercial transaction. The database has some useful keyword search functions and seems relatively efficient to use, but access is limited to subscribers and it has currently attracted only 60. Without some commitment to free-access to legislation and secondary writing on law, the average citizen and businessperson in Armenia will have no way of discerning, much less understanding, a rapidly changing legal environment.

d. Trade and professional associations

The most active trade organization in Yerevan appeared to be the American Chamber of Commerce (AmCham), which de facto represents most foreign business interests in Armenia, with the exception of smaller investments by Diaspora individuals, some of whom regard it as expensive and remote from their interests. AmCham has presented a series of seminars on different aspects of transacting in Armenia. Its latest dealt with e-governance and covered some of the electronic aspects of contracting. On balance, the seminar was pitched at the level of legal development in Armenia at the moment, that is a focus on the applications of digital technology for disseminating basic information about law (e.g. constructing a government legal data base of legislation and court decisions), rather than the more detailed aspects of e-commerce such as electronic forms and digital signature.

It was not clear to us that AmCham or any other trade organization had played any significant role in promoting the standardization of contract forms in Armenia. Individual businesspeople interviewed showed a marked disinclination to reduce contracts to writing. Businesspeople we spoke with stated that the cost of drafting and using contract forms is unjustified in situations

where the courts are unreliable and recovery against a debtor unlikely. Oral agreements based on cash were preferred in a number of sectors. Oral, cash-based transacting avoids default risk. For some businesses, it also has the advantage of evading the direct application of regulations such as labor law and sales tax.

Foreign investors and those engaging in more complex transactions import contract forms from abroad to cover that transaction type and that these de facto become the "industry standard" for the time being. In lending to small and medium sized businesses, one financial institution uses standard-form contracts but the large sign inside the front door was more revealing about the level of contract sophistication: "All borrowers must make repayments every month, no exceptions". Although the *Civil Code* contains no explicit duty to explain standard form contracts to other parties who are commercial entities or consumers (and although there is no consumer contract law per se) one banker told us that the law governing banks is explicit about the borrower's right to proceed against banks for misrepresentation or fraud. His view was that this makes lending institutions relatively careful in explaining terms to their clients. Foreign lawyers told us that their input to government on the adoption of international standards in contracting is, as with legislative drafting, nil.

5. Market for Improved Laws

We observed no demand for improved contract law in Armenia, but strong demand for improved understanding of the existing legislation and for implementation. Both local and foreign businesspeople regarded the contract law framework as stable and adequate, but were critical of barriers to implementation, including the taxation system, corruption (particularly in customs, licensing authorities and the tax office) and the inability to enforce judgments, which makes use of the court system impractical. Our reading of the *Civil Code* is that it is currently sufficient for, and probably exceeds, the immediate transactional needs of the majority of Armenian individuals and firms. A key systemic limitation for contract and commercial law is the availability of law enabling a range of secured lending. Once this is in place, it will provide the economic basis for structuring more complex contract transactions than are currently possible.

a. Government support

There is some evidence of high-level support for contract law within Armenia. The Minister of Justice, for example, identified civil procedure reforms and innovative judicial training as key priorities, both areas that would significantly improve the efficacy of contract law. The *Civil Code*, however, has also been an area of controversy. The Chair of the drafting Committee reportedly clashed with the President and has been removed from government responsibilities, which limits the opportunity to draw on the experience he developed during the drafting process. This is significant if you consider his observation that no one in Armenia (including himself) actually thoroughly understands the *Civil Code*.

Government officials seemed less concerned about the capacities of the legal profession and allied providers of contract law advice on the ground such as notaries and *juris consultants*. This is in marked contrast to comments by the Dean of Yerevan State University Law School who was deeply critical (and self-critical) of the state of professional legal education on commercial law generally. He expressed the view that the Law School would like to become a provider of continuing legal education, but that their capacity to do so at present is limited. He also observed

that, although the American University Law School is a achieving strong results on the basis of its more selective intake of students (a luxury that the state university does not have), the proliferation of a large number of private law schools in Armenia in the absence of effective quality control poses a challenge for the overall quality of legal education and by extension, legal services.

b. Donor Support

It was clear to us that the donor support for institutions such as Yerevan State University Law School has resulted in tangible support for contract and commercial law (e.g. a textbook series, desktop publishing capacity, computer lab and access to legislative database). It is equally clear that these gains are fragile and dependent on continuing external financial support.

c. Professional Associations

The average citizen or businessperson's access to legal advice on contract in Armenia at present seems quite remote. At the top of the pyramid are international lawyers who run western-style legal practices and predominantly act for foreign investors. The services they provide are roughly comparable with what a small or medium sized practice in the developed west could offer, albeit that they have better access to government elites and limited access to draft law, statutes and case law. We interviewed a number of local lawyers who have established small offices following the 1998 reforms, but who operate as 'one-stop-shops' for business advice, tax advice and legal consulting. We were told that these new-look lawyers are priced far beyond what an average person could afford. In discussion, it was clear that they also aspire to serving successful domestic and international businesses in Armenia. The 'poor man's alternative' is the *juris consultant* or notary, who has even less transaction experience and very few resources. Although the Yerevan State University Law School expressed interest in establishing a transactions clinic, they would be unable to do so without external funding. None of this is likely to change any time soon.

As noted above, the Bar Associations are potential vehicles for contract law training, input on reform and dissemination of information about international standards. However, there are no programs in place at present to effect these. By contrast, an EU-funded NGO has been successful in mounting training programs for small and medium sized-businesses both in the capital and in the regions to introduce the shape of the new contract and commercial law reforms. This NGO also provides legal advice on issues such as contract drafting and is slowly building a client base. Demand is slow because legal awareness is low. As the project head observes "Everyone in Armenia thinks that he can write a lease, particularly when it is based on a personal relationship".

d. Mechanisms for law reform

The sheer size of the Armenian *Civil Code* makes its claim to comprehensiveness strong in the minds of many stakeholders. We could discern no plan in place for the regular review and revision of the *Civil Code*, nor any real appreciation that it would, in time, require revision. Given its relative newness and the limited way in which it is being implemented at present, this is not surprising. What we can expect, however, is that a cluster of special laws dealing with

areas such as secured lending, equipment leasing, commercial leases, consumer contracts and licensing will be needed when and if the economy develops.

e. Market for Implementing Institutions

In general, businesses both, local and foreign-invested, are either dissatisfied with the courts as implementing institutions for contract or simply regard them as irrelevant. There is no private-sector competitor in the provision of dispute resolution or transactions enforcement. In part this is structural, for example the absence of law supported secured lending means that proxy enforcers such as banks have little role to play in the current transaction environment. Where self-enforcement through choice of transaction partner, or reliance on relational ties is possible, formal contracts and courts to enforce them are simply hypothetical. The political dimensions of the problem are also acute. To the extent that powerful or well-connected contract players, including foreign investors, can call on political interference and politicians are willing to pressure the judiciary directly, the judiciary as an institution is likely to remain eviscerated.

f. Market for Supporting Institutions

Whether businesses in Armenia can imagine contract transactions beyond the parallel universe of informal, self-enforcing contracts in Armenia is a question requiring further study. One of the obvious gaps in the contract system is the role of intermediate institutions such as banks, insurers, finance companies and government agencies. The state-owned banks were described to us as being bureaucratic, not service-oriented and relatively slow to predict and respond to market needs. Insurers exist, but businesspeople described them as weak, offering high rates and being untrustworthy i.e. "If something happens you cannot be sure that they will cover you". Government agencies, particularly Customs, the Tax Office and the business licensing divisions of municipal government were universally derided for their lack of competence and blatant attempt to siphon money from businesses perceived as successful. What this means is that ordinary commercial contracting is designed to avoid or compensate for the lack of intermediate institutions.

A number of businesspeople we interviewed also commented on the lack of trust-based voluntary association within their business sector. Businesses tended to remain separate, and to cultivate their own political contacts (often as silent partners or participants in profit-sharing) and to navigate and negotiate their encounters with government agencies separately. In at least a couple of cases, owners of domestic businesses saw their enterprise as a kind of (deserving) government concession, rather than a business intimately connected with the fate of other businesses in its sector. In once case, where a new market entrant was assisted by a competitor, they commented that this was "an uneasy relationship … you never know for how long and on what terms someone will remain a friend". Whether it is meaningful to talk about a "business community" in Armenia or "business communities" in different sectors is a question that requires more investigation. Unless we can identify the sense of shared interests and the pragmatic trust that underpins voluntary associations, the absence of formal artifacts of cooperation, such as standard form contracts, industry publications, mechanisms for alternate dispute resolution or forums for professional development should not surprise us.

Unless institutional capacity to understand and implement law in Armenia is strengthened, the recent and draft amendments to formal law risk becoming dead letters. Strategies to strengthen institutions (including those in the private sector) should be possible: as one lawyer commented, "The Armenian economy is smaller than a corporation".

F. Foreign Direct Investment

1. Overview

There is a debate in legal development circles whether foreign direct investment (FDI) Codes are needed. Opponents to codes argue that they are unnecessary, add no particular value, and can distract from the real issue, which is the overall climate for investment of any sort, not just foreign investment. Proponents insist that the code is a useful tool for identifying those issues that are important to foreign investors, and, by putting them all in one place, send a message that foreign investment is welcome. Armenia provides a solid case study for those who would do away with foreign investment Codes altogether.

One commentator has described the Armenian foreign investment regime as "The Cinderella Syndrome" in which the only real hope for the future is seen in marrying the prince – that is, attracting large foreign investors. The focus of investment promotion is on large risk-taking investors who will ignore local conditions and invest anyway, presumably then carrying the economy upward with them. Good foreign investment can certainly have such a positive development impact, but Armenia does not currently have the environment needed to attract such investment or to enable such investment, if attracted, to have the hoped-for multiplier effect. There appears to be a poor understanding of the factors that influence investment decisions among those guiding investment policy, with extensive tax breaks being offered to overcome the lack of attractiveness in the general investment climate.

Better foreign investment laws are unlikely to have much impact on the quality or quantity of foreign investment in Armenia. Better conditions – including the opening of the borders with Azerbaijan and Turkey – will.

2. Legal Framework

The legal framework for FDI in Armenia is generally in keeping with international standards, although some reforms are needed in the area of real property ownership, as further discussed below. The regime is set forth in the *Law on Foreign Investments*, a rather efficient document with only 25 articles. Although there are a number of references to other legislation, the law captures the bulk of the framework in its brief contents.

Aside from the *Law on Foreign Investments*, the country is currently a signatory to a number of important international treaties, including Bilateral Investment Treaties with the United States, many EU countries, and several of its neighbors, but not Azerbaijan or Turkey. It has free trade agreements with the FSU states, other than Azerbaijan, as well as most favored nation status with the EU, U.S., and a dozen other countries. These agreements, plus application for WTO and EU membership have been positive influences in moving Armenia toward international standards for foreign investment.

With respect to non-discriminatory treatment, Armenia has gone too far in some areas and not far enough in others. The investment incentives available for those who invest $1 million or more are available only for foreigners, suggesting that there is a mistaken belief that investment by foreigners is more valuable per se than investment of the same level and in the same industry by Armenians. As a result, Armenians who have the capacity to meet the threshold have overcome the restriction by becoming foreigners – they emigrate to Russia or other countries and either obtain foreign citizenship or create foreign companies, then bring their money back to Armenia. This is completely legal, but puts Armenians at a competitive disadvantage with foreigners by the extra costs and disincentives in "becoming foreign." Respondents did not offer any understandable explanations of why this was justified.

In addition, the incentives to foreign investors provide foreigners with anti-competitive advantages that local investors do not have. The tax incentives, although not particularly meaningful in the first few years, become meaningful overtime and allow foreign investors to undercut prices of local producers. Foreign investors are also exempt from of import duties on capital equipment, whereas locals are not. More seriously, qualifying foreign investors are protected from negative impact of legislative changes for the first five years of their investment.[33] Local investors, however, are subject to the virtually constant changes that have been underway in recent years, with no protection against deterioration in the investment environment that they thought would be in place when they invested. If the Armenian government wishes to incentivize economic growth generally, these measures are not helpful, and create a dependency on foreign investment instead of complementary incentives.

This incentive scheme goes too far in favoring foreign investors, but at the same time, it does not go far enough. Much foreign investment starts below the $1 million threshold, with conservative investors often beginning through small operations, distributorships, or agency relationships and then increasing their investment over time if the venture proves profitable. There are no incentives for these investments, which potentially comprise in the aggregate a much greater investment capacity than the larger investors being sought. The philosophy of investment incentives began changing in the1980s to promotion of investment generally, not just large, foreign inflows. Armenia would do well to reconsider its approach.

The FDI Law does not go far enough in yet another area: foreigners are not permitted to own land in Armenia. This prohibition would be a significant constraint to investment, but the impact is mitigated by the ease with which it can be bypassed. Foreigners may own 100% (or less) of an Armenian company, and that company may own land as a national entity, so the restriction (which is popular as a presumed protection against foreigners buying up the country) is virtually meaningless. Legal counsel for some foreign investors stated flatly that the restriction is not an impediment. As such, it becomes an indirect tax on investment that could be repealed with no significant impact. It may have a greater effect on individuals, who are also prohibited from owning directly, as they tend to be less willing to create shell companies for owning their property.

33 Article 7 of the *Law on Foreign Investments* provides a guarantee against changes to the "foreign investment legislation" in effect at the time of investment, but several practitioners are of the opinion that this includes foreign investment "regime", which might include tax rates, for example. It is not clear which is the correct interpretation, but it is clear that there is a need for greater legal and public education on this point.

Foreign exchange remittances do not pose any significant problems for investors. Those interviewed did not raise this as an issue. Local practitioners noted, however, that foreigners had a financial advantage over locals in that they had access to credit at reasonable terms, including trade and investment finance, which local investors do not have. The Armenian banking system, though improving through foreign investment in the banks, is still subject to the overall local risk environment, which has resulted in poor credit terms.

The Foreign Investment Advisory Service (FIAS) completed an analysis of administrative barriers to investment in 2000, which identified a number of processes that were overly bureaucratic or expensive and could act as a constraint to investment. For the most part, the constraints noted act as an irritant to larger domestic and foreign investors who have the resources and political clout to overcome them. For smaller local investors, however, the cost of such constraints can keep them out of the formal sector. Some – such as the excessively lengthy company registration procedures – have been addressed, but respondents familiar with the study generally thought that little had been accomplished in addressing the problems. They suggested that the Business Support Council – a ministry-level committee created to remove administrative barriers – is working on an ad hoc basis to address problems affecting individual investors, and not the investment climate as a whole.

Armenia has only partial success with respect to protection against expropriation. The Law properly guarantees freedom from expropriation of assets by the government, except in extraordinary circumstances compatible with general principles of international law. Armenian law further guarantees that in the event that the government must exercise eminent domain and take property, the owner will be compensated swiftly and justly. These provisions are a necessary part of an attractive foreign investment regime. However, there were reports of several takings by the government in which the investors did not receive swift or just compensation. Without a court system in which the government can be held accountable for such actions, the law is only as good as the government's reputation. There is currently some doubt about how good that is.

Foreign (and domestic) investors also look for a dependable, predictable system of dispute resolution as a basis for their investment decisions. As already noted throughout this report, such a system does not yet exist. The courts are unpredictable and unreliable. One foreign investor reported that it was possible for them to manipulate decisions through inappropriate influence, but that they would prefer to have a system based on established rules of law, knowing that competition in influence was completely unpredictable over the long run. The lack of a good court or arbitration system increases both costs and risks for investors, requiring higher returns for those not too discouraged to invest.

This weakness in the dispute resolution and enforcement system bleeds over into other areas. Trademark, patent, copyright and other intellectual property protection is generally very good under existing law. It is not clear, however, whether the courts can or will enforce the law effectively. Several large firms, such as Coca Cola, are able to maintain their intellectual property, and the growth of information technology firms in Armenia suggests that rights are being observed, at least for large investors. On the other hand, pirated music CDs and videos are

readily available everywhere in Yerevan, suggesting that any observation of copyright in artistic materials is observed only in the breach.

A number of foreign investors complained that although the laws on taxes, customs, and tariffs were good enough, they were subject to discriminatory enforcement. One noted that well-connected competitors were able to by-pass customs and undercut their prices, while others complained that they were constant targets of tax audits and requests for prepayment of taxes, as well as out-and-out bribes. They believed that their relatively high profile as foreigners who were presumed to have more money than political influence subjected them to this "special" treatment, which was having a chilling affect on new investment as information on this has spread to potential investors.

Although, on the balance, Armenia's FDI regime is good, this is a case where "good laws are not enough." Foreign investment has been decreasing over the last few years, dropping almost in half between 1999 and 2000. The Diaspora, which enthusiastically arrived shortly after independence, has markedly less interest today, and many Diaspora investors have liquidated their investments and left.

3. Implementing Institutions

The Armenian Development Agency (the ADA) was established in 1998 to promote foreign investment and exports. Intended as a one-stop shop for foreign investors, it is supposed to assist investors in bypassing bureaucracy and implementing projects. This mandate is not altogether feasible – there is even some international movement away from the idea of one-stop shops now – so it is not surprising that the ADA has not been altogether successful in fulfilling it. Even so, the ADA is generally perceived to be rather ineffective.

The ADA has recently undergone a number of staff changes. Current staff seems to have a good understanding of many of the problems facing investors in Armenia, including the lack of information regarding laws and regulations, as well as reports of uneven tax enforcement. They are familiar with the administrative barrier problems identified in the FIAS study, and are aware that there is not yet a systematic approach to addressing these problems. In light of the various problems, the ADA is seeking to attract "risk takers" to invest in Armenia.

The ADA also has a good understanding of marketing. Unlike many investment promotion agencies in developing countries, they are targeting their investment information to potential investors in identified markets for specific Armenian investment sectors. Currently, they are focusing on chemical and electronics industries based on a qualified labor force. They would like to conduct more in-depth studies on the comparative and competitive advantages for these sectors, but do not have sufficient funding. Funding for trade shows, marketing trips, and face-to-face promotional meetings with potential investors is insufficient.

As noted, the private sector is not particularly impressed by the effectiveness of the ADA. This is in part due to the unrealistic nature of a one-stop shop, which simply cannot negotiate effectively on behalf of ministries and investors, who eventually must meet. It is also due to a questionable approach. The notion that Armenia is seeking "risk takers" only signifies the underlying problem. The underlying national market is minimal, so that investors in Armenia

will be looking at the larger regional market for export and trade. With two of the borders closed, cutting off crucial trade routes, there is very little market potential at this time, and no certainty as to when those borders will reopen. The investment climate in terms of certainty, stability, predictability, and enforceability of agreements is very poor, as has been explained throughout this report, so that only risk takers will be interested. The problem is that only those risk takers who do not need to worry about transport – such as software developers – are likely to have much interest at this time. Fortunately for Armenia, there has been a good deal of very successful investment in software development and information technology.

Aiming at risk taking also ignores the underlying economic rules regarding investment. Risk takers require higher returns on their investments to justify the risks. "Bread and butter" investors in low-margin, high-volume industries are simply not interested in risky environments. Accordingly, the ADA could serve a very important function in transmitting investor concerns to policy makers and enforcement officials, to help the government understand the highly negative investment impact of the current environment. They would also do well to provide statistics on captured and lost investments, so as to provide better policy information. The ADA is not adequately filling these roles.

To their credit, the ADA has an uphill battle to promote investment in a land-locked small market beset by problems of corruption and bureaucratic incompetence in the import/export offices. Strategic rethinking of the role and mission of the ADA would probably be beneficial.

4. Supporting Institutions

Government entities. The Armenian Customs Service cannot properly be called a supporting institution in its current state. Rather than support foreign investment, this bureaucracy actively constrains and inhibits investment through inappropriate application of laws and tariffs, inappropriate and inconsistent enforcement of processes, and widespread rent-seeking behavior. The private sector respondents who addressed this issue were unanimous in their displeasure with customs. Serious reform is needed, and, fortunately, should be beginning now with a new USAID customs project that was recently started.

Notary services are definitely not adequate given the number of required notarizations, but on the other hand, are not necessary either. Most of the notary services required could be provided by corporate lawyers or others just as effectively, faster, and at comparable cost. Reform efforts for notaries would do well to focus on removing their official cartel status and opening competition for services.

Intellectual property registration (trademarks, copyrights, patents, etc.) could use additional study. The current system is not currently up to international standards, yet there are also not a great number of complaints about the Patent Office, which handles these registrations. It was noted that the Patent Office is unnecessarily involved in clearing names prior to company registration, which is not the normal practice in the developed or developing world. Name use can be checked at the company registry, and should be, but this is a revenue producing activity for the patent office that is not likely to change easily.

Professional associations. Although the local Bar Associations are not organized around foreign investment law issues, there is certainly an adequate supply of lawyers for the current level of investment. A number of locally and foreign trained attorneys are available in the market and compete for clients. Investors voiced no complaints in this regard.

There are also a number of adequately trained accountants for much of the investment work, but international accounting standards (IAS) are still not known or implemented adequately. The level of statistical data also seems low given the size of the country and the education level of the professional population.

Specialized services. Lawyers provide the necessary filing and registration services for foreign investors at reasonable market rates, so that there is no need in the existing market for specialized filing services. There is a need for credit rating services, however, and these do not exist. There are no formal or reliable means at this time of checking into the creditworthiness or trustworthiness of potential joint venture partners. It is expected that the banking community will eventually establish some form of information sharing on credit, but it has not happened yet.

Law schools and business schools need to update their curricula to address investment issues, including issues that face foreign investors. As with other areas of law, this gap in basic information is compounded by a lack of continuing legal education and other training and outreach initiatives to explain the recent and future changes in foreign investment laws.

Trade Associations and Special Interest Groups. The American Chamber of Commerce (AmCham) is very involved in raising issues regarding problems of foreign investors, and even held a breakfast meeting the U.S. Ambassador to voice concerns while the assessment team was in Yerevan. AmCham also brought together foreign and local investors to assist the new USAID customs project in identifying ongoing concerns and priority problems. The organization occasionally proposes legislative changes, but the impact is limited by the lack of any formal mechanism for proposing changes in a democratic manner.

The Armenian Assembly of America (AAA) is another interest group with potential to influence foreign investment policy. The AAA generally acts as a lobby in the United States for Armenian issues, and not as a voice of Diaspora investors, at least not in an organized way. That may be changing. If not, the Diaspora concerns will continue to be lost due to lack of any organization to focus and present their complaints and suggestions. Currently, Diaspora investment is in decline based on the very negative experiences of many of the former and existing investors.

5. Market for Reform of the Foreign Direct Investment Regime

The market for reform in this area is somewhat complicated. First, most of the demand is not for a change in the laws or incentive structure (at least for those taking advantage of those incentives), but for changes in the overall environment. Armenia is simply not an attractive investment location at this time for most forms of investment. The risks of failure due to non-market factors such as corruption, administrative barriers, and uncertainty in the legal regime (including dysfunctional courts) are very high for all investors, and the costs of doing business are unnecessarily high for the smaller investors. These frustrations are being expressed through

AmCham and some other groups, but Armenia also needs a better-developed civil society with a better capacity for formal complaint and lobbying.

Second, the demand for change in FDI law is by those who do not meet the $1 million threshold for incentives. Most of the foreign investors are being left out of the benefit structure for no clear reason. There are a higher number of low-end investors available and likely to invest, especially from the Diaspora, but they are not being courted.

Third, the entire incentive structure is misguided. Best practices in investment promotion now recognize that the first issue is whether a certain area of investment should receive incentives to stimulate investment. If so, it should be open to any investor who has the capital to invest, not just foreigners. The fact that numerous Armenians have become "foreigners" in order to capture the incentives is evidence of local demand for such incentives.

On the supply side, the country certainly has the internal capacity to supply these changes, both in terms of the number of qualified local experts who can assist with drafting changes and in terms of the ability of the government to accomplish changes (at least at the legislative level) when the political will is there. This does not mean that appropriate mechanisms for change are in place – they are not. Most change currently taking place comes through political connections or financial influence, neither of which supports the growth needed in this sector.

G. Real Property

1. Overview

The overall system of real property, including law, implementing institution, and supporting institutions, has been one of the more successful areas of reform for Armenia in the past ten years. Although deprived of ownership rights for more than 70 years under the Soviet system, the desire for ownership was never extinguished, only suppressed. Property rights were established in the Constitution, then made real early in independence as the new government began moving state property back into private hands. Today, most rural land is privately owned, with more than 2.5 million parcels distributed under temporary title certificates. In urban areas, most apartments have been privatized, but much other land still remains the property of the state. Most of the 44,000 registered real estate transactions in 1999 involved apartments. Current efforts in land reform have shifted to intensify privatization of land in the cities in order to spur economic development. Most real estate transactions involve Foreign-funded efforts to establish a modern registry have been highly successful, resulting in a combined cadastre and registration system under the State Cadastre Committee. All in all, the real property regime is on track.

2. Legal Framework

The right to own land is established in the Constitution of Armenia, adopted in 1995, and set out more fully in the Armenian *Civil Code*, adopted in 1999. The 1997 *Law on Privatization of State Property*, the 1999 *Law on the State Registration of Rights to Property*, and the *Law on Foreign Investment* establish the overall framework of real property law.

The legal framework, on the whole, is appropriate to both the present and future needs of the country. Some changes will, of course, be needed over time, but the fundamental provisions are in place. The law provides that land can be owned by individuals or enterprises, that it can be owned in common, and that the state cannot terminate property rights without compelling reasons, and only upon payment of fair value. This is supported by a successful and ongoing program of land privatization, ensuring that the legal rights are practical, not just theoretical.

The only major weakness in the legal framework with respect to ownership involves foreigners. In short, foreigners are not entitled to own land directly. This exception is based in part on a fear of foreigners buying the best land or simply buying "too much" and somehow denying Armenians access to the land. While many countries reserve some types of land for domestic ownership, Armenia's approach goes much further. Even so, the restriction is not meaningful. Armenian companies can own land, even if foreigners own 100% of the shares. Thus, an individual can own land simply by setting up a company to purchase it, and a foreign corporate investor can purchase land through the Armenian subsidiary or a land holding company. Several respondents noted that this ownership restriction was simply not a problem, but served instead as an added, affordable expense of ownership. This prohibition should eventually be removed under the foreign direct investment regime, but it is not a high priority.

Laws relating to transfer are also generally quite good, permitting sale, lease, bequest, and gift, with acceptable tax rates at this time based on the value of the property. Transfer is constrained,

however, by several factors. First, there is legal confusion between ownership and residence, with titles and rights given based on each. All residents over the age of eighteen must agree to the sale or transfer of property. In some cases, all occupants were granted actual common ownership rights, which is different. Occupancy rights allow individuals to hold the transaction hostage and seek rent for providing permission to sell. Another variation is even more bothersome. If a resident joins the military, the property cannot be transferred without the soldier's permission, but it is often difficult to find the soldier. These factors limit the operation of the real estate market, and increase risk in transactions.

Marital property claims create another level of difficulty. Real property owned by a spouse prior to marriage remains the individual property of that spouse after marriage. Land purchased during marriage is owned in common by the both spouses, even if obtained in the name of one spouse only. The problem arises in the practice of men purchasing and selling property without registering their wives' interests. In the event of divorce, the ex-wife will have a claim on the commonly owned property against a bona fide third-party purchaser, even though registration does not indicate any such interest. In response, some third parties and lenders have asked that men prove they are not married if buying in their own name, which is legally impossible. This problem can best be handled through laws relating to fraud. A few well-publicized prosecutions of individuals who have sold or encumbered land while withholding information about marital claims will go a long way toward changing behavior.

While it is generally difficult to evict defaulting tenants or buyers, the situation is made worse by restrictions on the eviction of occupants under 18 or over 60. Banks are very hesitant to lend if they will face this situation, thus reducing the availability of credit to young families, newly married couples or pensioners for any long-term lending. The law eventually needs to be modified so that someone other than the lender or landlord is responsible for the social safety net for evicted minors and pensioners.

The quality of the legal regime for mortgages is mixed. The law certainly permits mortgage lending, the use of real property as security for various types of transactions, and even permits eviction for non-payment of loans. However, as noted previously, the restrictions on eviction increase the risk of loss to lenders, as it is not always clear that eviction will be possible. Moreover, the process required for foreclosure is extremely protective of the debtor, with the law regularly interpreted against banks. These restrictions are understandable in the context of independence, when the right to private property was finally re-established after 70 years of soviet ideology, but the high level of protection against loss is now backfiring by reducing or eliminating the value of the property as capital. Real property does not provide the leverage for credit in Armenia that is found elsewhere, as reflected in the Central Bank rules that do not differentiate between secured and unsecured loans for reserve requirements. At this point, the inability to enforce effectively against pledged property means that security does not lower risk and therefore does not lower the cost of credit.

For development of property, respondents provided mixed signals. The overall legal framework was considered adequate, but real estate professionals found that the licensing, zoning, and authorization processes were unnecessarily burdensome and subject to corruption. Not all felt strongly about this however, for some viewed it more as a minor nuisance than a constraint. Although the law permits most uses of the land, ownership does not include mineral and

subsurface rights. These rights of mineral exploitation must be purchased separately from the government.

3. Implementing Institutions

a. The Land Registry

The cadastre and registration system, under the State Cadastre Committee, is one of the more significant success stories in the overall commercial legal and institutional environment for Armenia. With significant past and ongoing aid from USAID and other donors, Armenia has set up a modern system of land registry in which the registry and cadastre are combined. The SCC is staffed with very competent professionals who run the cadastre and oversee the registration system, and who have worked very effectively in implementing and developing the underlying computerized system. Eventually, the system can go to an Internet based program to allow greater public access to records, but for now it is working adequately. In fact, the SCC has the capacity in terms of infrastructure and human resources to host the pledge registry for movable property, once created. [34]

Among other successes, the registry has reduced the time for registration to about 15 days. Faster registration is possible, but not frequent, and there are certainly exceptions involving longer delays. Users, however, are generally very positive about the improved performance. Further improvements can and should be expected as the system becomes more routine.

Some users complained that the faster service still requires bribes. This was not a universal experience, but underscores the problems of institutional reforms in a system where government employment is as much as system of self-enrichment as of public service, if not more so. These same users thought that the overall performance was better, but that pockets of corruption still remain. They were not concerned with the price of the bribes required – which they felt were affordable within the overall costs of real estate transactions – but that the improved system had not eliminated this aspect yet.

The only other significant complaints about the registry system came from real estate professionals who noted that they did not have sufficient access to information in the registry, which is supposed to be public. This problem had two sides. First, the registry is not fully operational in terms of its ability to provide information or allow access to it. More important, however, was the sense by users that the registry did not wish to permit realtors or others to have access to the information. Even though the records are public by law, the registry often permits only the parties to a transaction to have access to records regarding the transaction or the underlying property. This limitation on public access will act as a constraint on the development of effective credit information for an improved banking and credit industry unless it is eventually addressed.

[34] The SCC is clearly qualified for this function, and the staff was very enthusiastic about the possibility of creating a pledge registry. The political considerations may dictate other results, however.

Users generally praised the changes in the registry, including the overall service orientation of the staff, other than the exceptions noted. The SCC, with donor funding, has developed a number of publications and brochures for users to ensure better understanding of processes and functions.

The donor community for further improvements is providing ongoing assistance in the system and in land registration and titling. Judging from success so far, this should continue to be a very profitable area of donor investment.

b. The Courts

Complaints about the effectiveness of the courts in enforcing agreements related to real property were universal. As in other areas of law, the courts are simply not functioning effectively. Users at all levels noted that it is extremely difficult to enforce real estate contracts, and that this lack of enforcement directly reduced the willingness of banks to lend or lower their interest rates. One project office noted that they had successfully prosecuted a default under a micro lending program, but the costs associated were borne by the project, and could not generally be maintained profitably without such a subsidy. Thus, while it is possible to succeed in court, it is expensive in both time and money.

Once a lender is able to obtain a judgment, a new set of problems arises. As already noted, the law is highly protective of property rights, and thus makes it difficult to repossess property through eviction. In addition to these legal constraints, the enforcement mechanisms are not very good. The bailiff system does not function effectively, giving rise to some use of self-help. Several respondents commented on the need for "bouncers" to forcibly evict recalcitrant debtors. This is not a positive sign for the economy. Unless the state acts decisively to ensure proper enforcement, there is likely to be an increase in the use of potentially improper enforcement.

Eviction is not the only problem. Assuming that a bank can repossess the property, the bank will not be able to sell it based on market demands. Currently, the law permits parties to agree to private sale by auction in the event of non-payment and attachment, but the courts and bailiffs do not permit this. The bailiffs have created a de facto monopoly for this service. Respondents complained that the system used was not transparent, market-based, or effective. Reforms are strongly needed to support the healthy development of Armenia's real estate market.

4. Supporting Institutions

a. Notaries

Notary services received a mixed review by the real estate community. For the most part, respondents described a system of mediocre services at acceptable rates, with exceptions in both directions. Real estate agents, however, complained that the notaries have a legal monopoly over the drafting of real estate contracts and would like to see the system modified to permit realtors to provide the first draft of purchase and sale contracts, without the professional intervention of notaries. Due to assistance in 1995 by USAID, a number of standard forms have been created, but realtors do not have full authority to use the contracts. Users also complained of long delays created by the limited number of notaries, which are appointed to each region based on

population, not on the basis of the level of commercial need. For Yerevan, the demand far outstrips supply.

Notaries do provide valuable service as closing agents for real estate transactions. They do not pass title to a seller until all formalities have been properly fulfilled, including full payment of the contractual purchase price. Users felt satisfied with this aspect of their service, noting that proper notarial services provided protection against fraud. This type of service does not have to fall within the monopoly of notaries, and in many jurisdictions is handled by qualified professional closers (such as title insurance agents) based on market demand. Reform programs should include a re-evaluation of the utility of permitting to maintain this service as a legal monopoly.

b. Realtors and Real Estate Associations

USAID has provided substantial assistance to the real estate community, starting in 1995 with support for the development of the Armenian Realtors Association. The ARA still exists, but a number of its services have been curtailed since funding ended several years ago. Even so, it continues to lobby for change in the real estate legal framework and to provide useful information on prices, financing, and available property. The ARA seems to need renewed vision as to what kind of services it can provide that would attract paying members, despite the apparently high level of professionalism of its directors.

There are numerous realtors throughout Yerevan, which is where the vast majority of the real estate market operates. These range in quality, as they would anywhere, but the better organized realtors tend to believe that greater entrance and licensing requirements are needed to ensure proper quality. This could in part arise from normal desires to limit competition by making it harder for new entrants to get in, but the respondents did cite some specific problems of incompetence among "low end" realtors. Rates for real estate agents are based on the value of the property, and tend to be in the 5% range. Realtors actively work to bring buyers and sellers together, to obtain listings of property, and to show properties to clients, as they might anywhere in the world. The supply appears to be sufficient, so that increasing the entrance requirements through more rigorous licensing procedures should not have a negative impact on the market.

The amount of information about real estate varies. Several newspapers carry weekly listings of property, with occasional articles regarding the real estate market. A more comprehensive newsletter used to be published by the ARA, but they were unable to attract enough paying subscribers and advertisers to continue once donor funding ended. They hope to relaunch a newsletter, but do not yet have the means to do so. Even so, the information flow is probably sufficient in the current market for Yerevan, but is still insufficient for the interior.

c. Banks and Appraisers

Banks varied widely in their willingness to lend based on real estate. Several of the newer, foreign-funded or owned banks are active in the real estate market, but only on high interest, short-term loans. No long-term loans (10, 15, 20 years) are available locally.

Bankers noted several reasons for this lack of mortgage financing. First, as noted previously, mortgage lending is still a rather risky venture. It is difficult to enforce mortgages in court by their terms, then to repossess and auction the property in a commercially reasonable manner. Second, lenders note that their primary interest is not in being able to retake the property, but in being repaid. Due to poor business practices, including poor bookkeeping, poor company management, and lack of corporate governance, it is difficult to determine the viability of many loan applications, with our without any property as security. In other words, much of the lending is still very risky on a commercial basis.

Finally, banks and realtors note a lack of well-qualified appraisers of property and of loans. Banks and title insurance companies are often the drivers of development in this area, but Armenian banks have not yet developed sufficient expertise, and title insurance is not yet available as it is in the West. A number of realtors commented that the supply of appraisers for establishing market value at purchase was sufficient, but banks, at least, did not find that there was sufficient capacity to judge liquidation value, especially with a falling real estate market.

Reforming some of the weaknesses in the banking sector is complicated, at least in some banks, by the continuation of the historical practice of debtors providing kickbacks to the loan officers for approving a loan. Several respondents cited an established price of 10% of the loan disbursement to the person responsible for granting the loan. The Armenian Banking Association is pushing for better regulation and auditing of banks, which will help to attack this problem by uncovering loans that do not comply with reasonable banking requirements. Also, increasing competition in lending, especially by new banks, will help to provide market incentives for better policing of this corrupt practice.

The Armenian Banking Association is still nascent but is attempting to steer the course of reform in a modern, market-oriented direction. The ABA does some lobbying, and is able to get the attention of policymakers, but deplores the lack of any formal mechanism that would permit them to have more meaningful input to the policy and legislative processes.

5. The Market for Reform

Supply and demand have come together effectively in the numerous changes that have taken place in the establishment of the unified cadastre and registry. Most users were satisfied with the progress to date and are content with the direction of ongoing changes. In short, there is no significant demand for any substantial changes at the registry.

There is some demand for changes in the laws on property and mortgage, including removal of hidden liens and simplification of civil procedure regarding enforcement. In most instances, local professionals among the various associations are well qualified to draft or advise on these

changes, if they could have access to the system. Despite significantly unified interest and understanding in the ABA, ARA, American Chamber of Commerce, and other groups, concerted efforts for change continue to be afflicted by the lack of a system for change. The lawmaking process is still not connected to the private sector, so that there is no official feedback loop. Open debate will be necessary to ensure that all interests are properly represented, and to ensure public education on the need for enforceable contracts, but this is unlikely under the current structure.

There is also unanimous demand among stakeholders in the real estate community for reform of the courts to ensure the enforcement of commercial obligations under the existing law. This ongoing gap in the legal and institutional framework has had and will continue to have very serious negative effects on the development of the Armenian real estate market. The creation of the new system of Economic Courts may supply the needed answer (at least at the court level), but much training and assistance will be needed to ensure that the reforms function. The state will also need to permit and supply effective enforcement through the bailiff services.

H. Trade

1. Overview

Armenia developed an advanced industrial sector during the Soviet era consisting of production of machine tools and textiles and an agricultural sector consisting of large agro-industrial enterprises. The break-up of the Soviet Union and the conflict in Nagorno-Karabakh led to a significant contraction in Armenia's GDP, estimated at 50% between 1991 and 1995. An ambitious IMF-sponsored economic program in the early 1990s, focusing on privatization and macroeconomic stability, paved the way to resumed economic growth in 1995.

Exports in 2000 were estimated to total $284 million, comprising diamonds, scrap metal, machinery and equipment, brandy, and copper ore. Imports in 2000 were estimated to total $913 million, chiefly consisting of natural gas, petroleum, tobacco products, foodstuffs, and diamonds. Much of the resulting trade deficit was offset by continuing infusions of international aid[35] and foreign direct investment.

Armenia's major export destinations are the European Union (35%), followed by Russia (14.9%), the United States (12.7%), Iran (9.3%), and Georgia (5.2%). Armenia is a member of the CIS free trade zone and has free trade relations with Georgia, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, and Ukraine.[36] In addition, Armenia has Most Favored Nation trading status with most of its major trading partners, including the U.S and the European Union.

[35] Armenia receives international assistance from a number of sources, including the European Union, wealthy members of the Armenian Diaspora, and the U.S. Government.

[36] See: www.cis.minsk.by/ english/eng-zona.htm

While Armenia's official population statistics indicate a population of 3.8 million[37]; this number is probably overstated. Many observers consider that anywhere from 25% up to 50% of the population has emigrated to Europe, Russia, and elsewhere in search of economic opportunity. Unemployment and underemployment appear to be widespread, especially outside the capital city. Unemployment in 1998 was estimated to be 20%[38], and per capita GDP (modified through a purchasing power parity index) is estimated to be $3,000.

a. Geographic Considerations

Access to international markets is particularly important for Armenian businesses and consumers. Armenia is a landlocked country, located in the southern Caucasus, and is bordered by Azerbaijan, Nagorno-Karabakh, Iran, Turkey, and Georgia.

Contributing to the Armenian economy's persistent sluggishness are the low intensity conflicts that permeate the Caucasus. The war with Azerbaijan over the region of Nagorno-Karabakh led to closure of all Armenian border crossings with Turkey and Azerbaijan. This is significant because Armenia's principal transportation corridors with the region run through both those countries[39]. The unfortunate result is that Armenia's economic lifelines are concentrated in a handful of road and rail connections with Georgia[40] and a single road link to the Iranian border. These links, however, are in poor condition and difficult to traverse.

Rail freight connections to Russia and beyond have also been interrupted, as trains cannot move between Georgia and the hotspots of Abkhazia and Chechnya. Armenian Airlines, the national carrier, flies to many international destinations, including Istanbul.[41] However, the airline is effectively bankrupt and cannot sustain itself in its present form.

These problems put Armenian exports at a significant competitive disadvantage due to increased transportation costs.[42]

b. International Economic Relations

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37 Source: Armenian Development Agency, Armenia Country Profile 2001. The CIA World Factbook 2001 provides an estimate of 3.34 million people (July 2001 estimate).

38 To be sure, the official GOA estimate for 1998 was 9.3%: CIA World Factbook

39 Armenia shares a long common border with Turkey, running along the biblically mentioned River Araxes. Yerevan, the capital, is less than 20 miles from the Turkish border. The best highway to Iran runs through the Nakhichevan exclave of Azerbaijan, closed now to Armenian traffic. Transport to Iran nowadays must use a roundabout mountainous route that takes 8 or 9 hours, rather than the previous three-hour journey through Nakhichevan.

40 Armenians frequently lament the poor road and travel conditions on the Georgian side of the Yerevan-Tbilisi highway. Disrepair means that traffic must crawl at 10-20 mph to avoid potholes, increasing travel time three-fold. Moreover, drivers of Armenian tagged cars claim that they are subject to frequent traffic stops by anxious Georgian traffic police.

41 Armenian Airlines is wholly owned by the Government of Armenia, and it is unlikely to be privatized any time soon, owing to the general downturn in the aviation industry after 9/11/2002.

42 One import-exporter considered that costs of shipping comprised 30% of the final price of goods for buyers in Western Europe. In effect a 30% export tax.

Armenia has entered into a number of bilateral and multilateral agreements to break out of its economic isolation. For example, trade relations between Armenia and the European Union (EU) are governed by a Partnership and Cooperation Agreement (PCA). The PCA defines the legal parameters for trade between Armenia and the EU, and specifies trade concessions such as most-favored-nation (MFN) status and access to the Generalized System of Preferences (GSP). Measures for phased liberalization of trade in services, FDI, capital transfers, and protection of intellectual property rights are also addressed. The PCA also creates a framework for on-going cooperation, primarily in the form of an annual Ministerial Cooperation Council, and a Parliamentary Cooperation Committee. Armenia's customs regime substantially conforms to European standards, where customs value is defined as the sum of the sales price, transportation costs, freight, insurance, storage fees, and any other costs not foreseen in the contract price.

A bilateral investment treaty and a treaty on double taxation govern trade relations between the U.S. and Armenia. Under this agreement, the parties extend mutual Most Favored Nation (MFN) status.

The Republic of Armenia began the accession process to the WTO in 1995, with active negotiations ensuing through 1996. By the end of 1997, however, attention to accession negotiations in Geneva appear to have wavered, and Armenia reportedly devoted most of its efforts in this period toward implementation of laws that would bring its regime closer to WTO provisions. During bilateral consultations at and after the Seattle Ministerial Conference at the end of 1999, Armenia re-energized its negotiations with interested WTO Members, particularly with the United States. This has advanced the process, both in market access and protocol discussions, to the point where there appear to be only a few substantive issues remaining to be resolved prior to preparing the completed protocol package for submission to the Working Party (WP) for review and adoption and then to WTO Members for final approval.

With respect to market access commitments, Armenia is in the last stages of completing negotiations. Consensus is near on the terms for tariff and services commitments, two of the four elements of the accession package. As of January 2002, final agreement had not been reached on how to calculate the value of Armenia’s agricultural domestic support, the so-called aggregate measure of support (AMS).

Concerning protocol commitments, the most important remaining issues concern Armenia’s enactment of legislation to amend its legal regime to bring it into line with the provisions of various WTO Agreements, e.g., the Agreements on Trade Related Aspects of Intellectual Property Protection (TRIPS), Technical Barriers to Trade, Sanitary and Phytosanitary Measures, Import Licensing Procedures, and Customs Valuation. Armenia has submitted its revised legislation on these and other issues concerning implementation of WTO provisions to the WP for review. A hand full of other, sometimes fundamental, issues remain to be examined and/or resolved, including the critical issue of application of the value added tax (VAT) to agricultural products.

WP Members have not yet reached formal agreement on the text of the WP report and protocol. Discussion at the last WP meeting in June 1999 has identified a number of outstanding issues, however, and the government of Armenia is moving to address them, with a view to closing out

the negotiations in the near term. Therefore, notwithstanding that the date of Armenia's WTO Membership cannot yet be determined, it is an appropriate time to consider what form of decision making and operational organizations will be necessary for Armenia's participation in the WTO, both for the transitional period leading to full Membership and for the stewardship of an active WTO Membership that will soon follow. Establishment of this machinery will also have implications for trade policy formulation outside the WTO context.

2. Implementing and Supporting Institutions

The key Armenian institution for implementing trade policy is the Ministry of Trade and Industry. This Ministry has a small, and needless to say, swamped staff that has responsibility for WTO affairs. The WTO accession effort itself is managed by Deputy Trade Minister Tigran Davtyan. There is no Armenian trade ministry representation in Geneva, where the WTO has its headquarters, although the government is seeking funds to do this.

Another significant institution is the Armenian Department of Customs ("Armenian Customs"), which is a component of the Ministry of State Revenue. It comprises the Central Customs Department, four Customs Houses (locations where cargo is actually cleared), and 11 Customs Points, including some that are currently not operating due to the Turkish/Azerbaijani border closings. Over 80% of all cargo clears customs at either the Araratian Customs House or at Zvartnots Airport (both serving Yerevan).

A new customs tariff was implemented in August 1996, and a new customs code was adopted on January 1, 2001. Armenia uses an ASYCUDA automated customs clearance process, but has not decentralized the clearance process outside of centralized customs houses to the border points. This ASYCUDA system is the same as that used in Georgia. Neither Georgia nor Armenia has attempted to harmonize the customs documentation so that a transit document issued in the country of entry but bound for a different destination could be used as the import document in the destination country. Moreover, Armenian Customs, apparently unique in the world, requests extra documentation for clearing imports that add complexity and create delays in trade. The Trade Ministry was preparing legislative amendments to deal with this issue in December 2001.

In interviews with importers, most related that Armenian Customs became noticeably more corrupt following the appointment of a new head in the fall 2001. Stories, which may be exaggerated, suggest that in order to expedite clearance, some customs clearance officers request kickbacks of up to four percent of the total value of a shipment, which purportedly exceeds the importers' profit margin on a given shipment.

3. The Market for Trade Liberalization

The market for trade liberalization is relatively weak in Armenia. While some government officials recognize the importance of trade and investment, many do not see what benefit WTO membership will bring. They point out the fact that Georgia, now a WTO member for several years, has not taken off economically following its WTO accession.

A formal, institutionalized process to develop trade policy options within the Armenian Government does not currently exist. Decisions appear to be made informally, based on personal

relationships between the key players. In spite of a Ministerial Decree establishing an interagency committee at the Ministerial level to coordinate trade policy, this Committee meets very infrequently and has, in practice, deferred decisions to a lower level. Moreover, there is no constituency that wishes to establish a more formal mechanism for trade policy formulation.

There are however, certain common principles basic to the stable and ongoing ability of any government to participate effectively in WTO policy making that they share. For example, one such principle is the need to provide for the broad participation of all interested governmental parties in the development of, and support for, policy decisions eventually taken. Such consultation can be a time-consuming and elaborate process of consensus-building and political evaluation, but it is important to ensure the maximum effect and credibility of the policies pursued. Provision also must be made for daily decision-making and the ability to respond quickly based on established policies.

Major economic concerns have direct access to government officials and politicians, meaning that they have little incentive to change legal frameworks for an entire system. They prefer to improve their enterprises' legal and tax treatment through ad hoc provisions, like getting a decree issued through personal intervention.

There are some institutions that carry the potential as a voice to represent trading interests, like the Armenian Chamber of Commerce. This group, however, sees only the pain and not the opportunity in trade regime reform. The Chamber is dominated by "old economy" holdovers who were masters in maneuvering the former Soviet bureaucracy for Armenia's gain. It remains to be seen when Armenia's "new economy" entrepreneurs better organize themselves and begin lobbying Parliament and the Ministries in a systematic, focused way.